42-E A93.27:224

United States Department of Agriculture

Economic Research Service

Foreign Agricultural Economic Report No. 224

# The International Monetary Fund and Low-Income Countries

Bela Mukhoti

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**THE INTERNATIONAL MONETARY FUND AND LOW-INCOME COUNTRIES**. By Bela Mukhoti, International Economics Division, Economic Research Service, U.S. Department of Agriculture. Foreign Agricultural Economic Report No. 224.

## ABSTRACT

Low-income countries' (LIC's) debt service payments exploded and their export markets collapsed when interest rate increases in 1981-82 triggered the worst global recession in 50 years. Higher oil prices and shifts in industrialized countries' monetary policies drove up the interest rates, severely worsening LIC's balance of payment problems. The International Monetary Fund (IMF) responded, but the conditions governing its assistance are controversial. IMF assistance, through adjusting the actual structure of the economy chiefly by restraining demand, often hurts LIC's. This report discusses the LIC's financial difficulties, IMF adjustment programs and the theoretical controversies surrounding them, and contributes toward a medium-term adjustment program for LIC's.

**Keywords**: International Monetary Fund, low-income countries, Sub-Saharan Africa, conditionality, structural adjustment, exchange rates, devaluation, interest rates, subsidies, monetary policy, fiscal policy.

1301 New York Ave., N.W.
Washington, DC 20005-4788

April 1987



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# PREFACE

The past decade has been a time of great stress in the world economy, particularly for the low-income countries (LIC's) experiencing domestic and external financial problems. The rest of the present decade will likely be critical for overcoming these difficulties, at least in the medium term.

The International Monetary Fund (IMF) has played a crucial role in averting a greater crisis in LIC's as well as in world trade and finances. But the IMF's requirement that LIC's adopt certain policies as corrective measures for receiving IMF financial assistance (conditionality) has been controversial. At the root of these controversies lies the sharp differences in theoretical perspectives of different groups of economists and their lack of communication with each other.

Resolution of the LIC's problems is being impeded by another complex development in economics. Not only do the economists disagree about the theoretical basis for finding causes and solutions of these problems, but they do not even use the same language anymore.

The IMF has not yet worked closely with other development and assistance agencies to mesh its perceived short-term policies with longrun perspectives of the other agencies.

The challenge lies in resolving all these issues for a general consensus on an appropriate policy package needed for a longrun, relatively stable situation in global trade and finance. This report addresses these issues and attempts to contribute to the design of a new policy package.

This report was completed in 1986, and many developments since then show that many problems are better comprehended, and resolutions have been attempted. Nonetheless, recent events seem to corroborate the central viewpoints presented here.

# ACKNOWLEDGMENTS

Many thanks go to many people contributing to the preparation of this report, especially to Arthur Dommen and Cheryl Christensen for their support. Nicole Ballenger, Fawzi Taha, and Lawrence Witucki of the Economic Research Service (ERS), U.S. Department of Agriculture (USDA); Ronald Roberson of the Foreign Agricultural Service, USDA; Mary Maher of the Economics Management Staff, USDA; and Tony Killick, Pragapati Trivedi, Kishore Kukarni, Romesh Diwan, and Sam Bhatia read the drafts and provided many insightful comments. Tony Killick's and Mary Sutton's excellent exposition of the New Orthodox and Structuralist viewpoints formed the basis of my discussion on the two schools of thought. Betty Acton and Alma Young typed and prepared camera copy for this report.

The issues involved in this report relate to the early eighties, so the literature available for this short period was naturally limited. So my gratitude also goes to the authors of the many published and unpublished materials from which this report draws heavily (but I am solely responsible for the survey, presentation, interpretations, and conclusions drawn from these sources). Much information comes from numerous International Monetary Fund and World Bank publications and seminar proceedings, specific citations of which may not have been possible.

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## SUMMARY

The International Monetary Fund (IMF) has played a critical role in averting a global crisis in international trade and payments in the eighties. But the IMF requirement that low-income countries (LIC's) adopt certain corrective measures as a condition for financial assistance (conditionality) has been controversial.

IMF stabilization programs form parts of a consistent, well-structured monetarist approach to the balance of payments. But IMF-supported devaluation, interest rate changes, monetary contraction, and abolition of food subsidies in LIC's may jeopardize the longrun growth and development of LIC's. IMF assistance, through adjusting the actual structure of the economy chiefly by restraining demand, will be costly, especially in Sub-Saharan Africa.

The IMF has traditionally viewed the financial difficulties of economies requiring adjustment as problems originating from high demand, with a relatively stable supply. Only recently has the IMF begun to supplement its demand-management approach with programs that focus on the supply side of the economy.

This report analyzes the conflicting theoretical bases giving rise to divergent views on the causes and solutions of LIC's financial problems and explains the complexities involved in IMF policies, which are primarily based on New Orthodox/monetary theories. This report also identifies other areas that policies need to address. For many of these countries, developmental problems are more of an issue than debt problems. Stabilization with economic growth is the critical issue for the remaining years of the eighties.

Following the steep rise in oil prices in 1973, the economies of the industrialized countries experienced stagflation: low output, high unemployment, and high inflation. To limit inflation, these countries' monetary policies shifted in 1979, ushering in a period of sustained high interest rates. LIC's then had to cope with the effects of high interest rates. LIC's increasingly resorted to reserves, IMF credit, and reduced imports to sustain their economies.

Before 1979, LIC's were considered good credit risks because of their accelerated investment growth, even though external borrowing financed a large share of this growth. Beginning in 1979, economies of the LIC's deteriorated. As high interest rates worldwide triggered recessions in industrialized countries, the LIC's confronted a collapse of their export markets (mainly consisting of raw materials). Also, a high proportion of the LIC's debts were at variable interest rates or were short term, and so their debt service payments increased rapidly.

Commercial banks, increasingly concerned about the debt-servicing capacity of LIC's, cut private lending to LIC's in early 1982. Some major borrowers among the LIC's were unable to "roll over" their maturing loans, and thus bankers' confidence in lending to LIC's deteriorated. At the same time, domestic developments in LIC's worsened their ability to pay: inadequate or insufficient domestic adjustment of inflationary demand increases, coupled with rigid exchange rate policies and restrictions on trade and payments, pressured domestic demand so that LIC's were no longer competitive in international markets and had




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difficulties with their current account and overall balance of payments. In that situation, LIC's turned to IMF credit.

But LIC's have found the IMF policies and programs difficult to implement. IMF's conditionality measures have provoked a sharp controversy on the logic underlying IMF programs and policies. At the root of this controversy lie the economic theories.

This report examines two schools of thought that advocate structural change in the economy. The New Orthodox school proposes a demand-management strategy, supplemented by trade and exchange rate reforms, to improve demand by relying heavily on monetary rather than fiscal instruments. The Structuralist/Populist school instead relies primarily on foreign exchange rate and trade controls. This report argues that the monetarist approach to the balance of payments is not valid in certain countries or in some stages of the economic cycle. Country-specific situations must be analyzed before even rough estimates of the probable impact of policies on the balance of payments and on the economy can be made.

Adjustment by restraining demand alone is a high-cost strategy. The scope of conventional stabilization policies such as budget deficit reduction and credit contraction is more limited in LIC's than in industrialized countries, even when trade imbalances may be attributed to excessive domestic spending financed by credit and expansion of the money supply. But exogenous factors such as falling world demand for commodity imports, rising import prices, and high interest rates in industrialized countries have been considerably responsible for imbalances in the LIC's finances.

The theories underlying the IMF's use of currency devaluation are standard economic theories. However, the assumptions governing the application of these theories to the LIC's require close examination. One basic assumption is that a typical small LIC is likely to face (at least in the long run) perfectly elastic import supply and export demand functions. Another assumption is that the current account deficits of LIC's resulted from their expansionary financial policies, such as expanding government spending. The IMF program is also usually based on the assumption that exchange rate and trade controls do not exist, but such controls are actually pervasive in LIC's. The IMF also assumes that the LIC will use all of the IMF's recommendations as a package--a difficult task for most LIC's.

The IMF contends that administered prices are widespread in LIC's. IMF-supported programs often call for abolishing food price subsidies, which many LIC's impose to cushion consumers, especially urban consumers, from the fluctuations of the world market. Abolishing such subsidies is likewise no easy task for LIC's governments. Assuring stable, low food prices is considered by many governments as one of the instruments for maintaining social and political stability and also controlling inflation.

The United States has an important stake in the adjustment process from economic, political, and humanitarian standpoints. U.S. firms and banks depend on a healthy and growing developing world. The fallout from the adjustment process would affect U.S. diplomatic and perhaps even strategic interests around the world. American humanitarian efforts are thwarted by the declining levels of nutrition and resurging diseases often accompanying austerity measures in many LIC's.



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# THE INTERNATIONAL MONETARY FUND AND LOW-INCOME COUNTRIES

Bela Mukhoti*

## INTRODUCTION

The past few years have been a time of great stress in the world economy, with many countries, especially low-income countries (LIC's), experiencing acute financial difficulties, both internal and external.[1, 2] In this situation, the International Monetary Fund (IMF) played a critical role in averting a serious crisis in world trade and payments.

The IMF, a specialized agency of the United Nations, promotes international economic and financial cooperation among its members by collaborating on monetary problems.[3] Through its collaboration, the IMF helps expand and balance the growth of world trade, promotes exchange rate stability, and helps establish a multilateral system of payments for members. The IMF seeks to shorten the duration and lessen the degree of imbalance in the international balance of payments of its members. To achieve these goals, the IMF considerably increased its financing to support corrective economic policies in member countries during the eighties.

A country making use of IMF resources is generally required to aim economic policies toward achieving a viable balance of payments over a period of time so that the nation's total payments to foreign countries (the price of imports and outflow of capital and gold) match its total receipts from abroad (price of exports and inflow of capital and gold).

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NOTE: Italicized numbers in parentheses refer to literature cited in the References section.

[1] LIC's refer mainly to non-oil developing countries. For an analysis of different groups of LIC's and the nature and extent of their problems, see (*8*).

[2] Interest rate increase, slowdown in economic activities in industrialized countries, and deterioration in the terms of trade are termed "external" because the typical developing country has no control over these factors, or had no power to offset them. Changes in a country's fiscal deficit and movements in real effective exchange rate are considered "domestic" or "internal" because a country's economic policies influence both its nominal (undeflated) exchange rate and domestic input and output prices.

[3] The IMF has 143 member countries. These include nearly all the non-Communist nations of the world as well as certain Communist nations such as China, Romania, and Yugoslavia. Kampuchea, Laos, and Vietnam have maintained the membership of previous regimes. The IMF is managed by an executive board and a managing director, with ultimate authority residing in a board of governors, which meets annually.



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This requirement, known as conditionality, infers that balance of payments financing and adjustment must go hand in hand. Adjustment refers to stabilizing (bringing expenditures in line with available resources) and liberalizing (freeing prices to reflect the international cost structure) the economy. During the early eighties, the IMF's adjustment required strict conditionality and bank financing of part of the foreign exchange gap.

The IMF's adjustment requirement has drawn greater attention to the IMF's role in the economies of LIC's. It has also provoked appraisal of the logic underlying the IMF's policies and programs because these policies often imposed excessive hardships on member countries (*2*, *5*, *9*).

At the time of writing, the crisis management stage of adjustment has given way to a stage of managing stabilization with growth. The external deficits in LIC's have been reduced to a sustainable level. The current account deficit of indebted LIC's, after reaching $113 billion in 1981, fell to about $38 billion in 1984 (expressed as a share of goods and services, it declined from 21 percent to a record-low 7 percent).

Economic growth accompanied the improved external position. Output increased by about 4 percent for the indebted countries in 1984, 2 percentage points faster than in the preceding 2 years. However, this growth rate falls below most rates recorded before 1980. The IMF projects a 4.75-percent growth for the medium term, meaning living standards will grow at the slowest rate in 30 years.

Although this economic growth was the strongest in several years, it was unbalanced, and per capita incomes in many countries declined further. For example, output in Sub-Saharan Africa grew by only 1.5 percent, well below the estimated 3-percent population increase. Current account deficits of these economies have improved because of cutbacks in investment, implying slower future growth. Against this background, LIC's must direct policies toward ways to accelerate development and sustain a stable external position in the medium term. There is a greater need now to appraise the theoretical underpinnings of IMF conditionality to determine their appropriateness for the rest of the eighties, especially for the economies of Sub-Saharan Africa. The IMF needs to re-examine and redefine conditions for financial assistance (conditionality).

This report clarifies the theoretical controversies and also suggests an appropriate adjustment program for the LIC's. The theories are examined because many of the controversies on the appropriateness of IMF policies rest on underlying theories. This report also provides a foundation for country case studies, model building, and quantitative studies on the effects of IMF conditionality.

## CURRENT EXTERNAL FINANCIAL DIFFICULTIES

LIC's faced an adjustment problem at the beginning of 1981 different from that caused by responding to the oil price rise of the seventies: managing the effect of external interest rate changes. At the beginning of 1979, output in the industrialized countries had not yet recovered from the 1974-75 recession, which followed the oil price rise of late 1973. Stagflation--a combination of low output, high unemployment, and a high inflation rate (7 to 8 percent)--occurred in 1979. By late 1979, prices for oil, food, and other primary products had pushed consumer prices in many industrialized countries to the highest peacetime rates ever experienced.



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The priority of controlling inflation to stimulate growth and employment on a sustainable basis was repeatedly stressed at IMF meetings. Despite high unemployment, reducing inflation through monetary policy became a prime objective in industrialized countries, and marked a major policy change. As a result, the industrialized countries followed a highly restrictive monetary policy from late 1979 through mid-1982. Interest rates then increased substantially.

The rate of inflation fell by 1982, when consumer prices in the industrialized countries annually rose 7 percent, the lowest in several years. As a result, nominal interest rates considerably exceeded the rate of inflation, although they fell somewhat by the end of 1982, especially in the United States when tight monetary policies eased in August 1982. This was in sharp contrast to their relationship prior to 1979, when negative real interest rates hindered LIC's savings and produced an incentive to borrow from abroad. At the same time, demand for their export products was declining. Also, the world economy was in a recession by 1981-82, more severe than that of 1974-75, and the deepest and longest in 50 years. Late 1982 marked the worst of this recession, when unemployment rates soared to their highest levels since the thirties. The volume of world trade, despite the economic disruptions of the decade, continued to rise during the seventies (except for 1975) and into 1982.

## Historical Retrospective

Many developing countries, especially those who produced no oil, borrowed heavily after 1973, especially from commercial banks, to finance their deficits in balance of payments. Readily available credit from private sources, at favorable interest rates for that period, induced countries to borrow. Steadily rising deposits, especially as oil-exporting countries banked their oil revenues, induced creditors, particularly commercial banks, to lend (*26*). By mid-1982, the aggregate external debt of these countries amounted to over $600 billion, over half of which was commercial loans.

The major aid-providing agencies were concerned that the LIC's were borrowing the recycled OPEC (Organization of Petroleum Exporting Countries) surplus for financing their increased consumption rather than for their adjustment, because their postponing adjustment endangered their credit-worthiness. However, there was some evidence that the LIC's were able to use their high export growth to avoid needed internal structural adjustment. There was also evidence that their aggregate investment growth was higher than their aggregate consumption growth during the seventies. But borrowing sustained consumption in some LIC's and financed investment. Net foreign capital inflows did not discourage domestic savings during most of the seventies (*3*).

Whether such investment financed by foreign borrowing and domestic savings was productive or not is a separate issue. Despite increases in share of gross national product (GNP) going to investment in many LIC's, their GNP growth rate slowed after the first oil shock. Returns on investment during the seventies may have gone down, thereby lowering the debt-servicing capacity in many LIC's in the face of rapid growth in their external debt and servicing needs. There may have been some unproductive investment by both oil and non-oil exporting countries. Such waste, while undesirable, can hardly be eliminated in the development of LIC's; it occurs in industrialized economies as well. However, the investment productivity was sure to be affected by the prolonged period of negative or sluggish world economic growth. Nonetheless, the LIC's were considered good credit risks because their external debt financed their accelerated investment growth (*3*).



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Their situation deteriorated in 1979. Another rise in oil prices, a shift in the U.S. and other industrialized countries' monetary policy, and the consequent worldwide interest rate shock adversely affected the global growth outlook and world debt. As high interest rates triggered recession in industrialized countries, the LIC's were confronted with an explosion in their debt service payments and a collapse in their export markets because a high proportion of the LIC's debts was at variable or short-term interest rates (app. table 1). Therefore, their debt service ratio (the percentage that debt service payments represent of export earnings) rapidly increased from 15 percent in 1977 to 24.6 percent in 1982, before declining to 22.2 percent in 1983 (*6*).

The economic growth rate of non-oil exporting LIC's declined to 2.5 percent in 1982, and the growth rate of their trade volume dropped to less than 2 percent in 1982 from 9 percent during 1976-80. The rate of decline in growth was even higher for the three largest debtor countries--Argentina, Brazil, and Mexico--all of which experienced robust growth until 1978. Lower prices of primary commodities further reduced the export earnings of non-oil LIC's. As prices for oil and manufactured imports increased, LIC's trade positions worsened. The slowdown in world trade and high unemployment rates in industrialized countries made it more difficult for the LIC's to export.

The commercial banks began to lend money on a short-term basis in 1980 and 1981. LIC's export markets and their sharply increased debt service ratio further deteriorated. Private financing was cut back in early 1982. (Under these conditions, for example, Mexico informed the IMF a few weeks before the IMF's annual meeting in Toronto, Canada, that it was unable to meet its debt service payment.) Some major borrowers among LIC's were unable to "roll over" their maturing loans, and thus bankers' confidence in lending to LIC's deteriorated. Access to credit proved to be a criterion for further loans. That is, current account deficits and external debt-servicing capacity were considered financeable if LIC's had access to additional commercial credits.

A country was thus perceived to be creditworthy as long as it could borrow additional funds, and a country could borrow enough as long as it was judged creditworthy. In the absence of a more balanced analysis of the LIC's debt-servicing capabilities, the banking system panicked. This threatened a cumulative contraction of credit-financed imports which could severely damage world trade and the prospects for world economic recovery. The IMF, in fulfilling its broad mandate to promote expansion and balanced growth of world trade, responded.

## Payments Problems of LIC's

International economic conditions were less conducive to the LIC's economic growth and stability because of the combination of events by the end of the seventies. These conditions also aggravated the LIC's domestic economic management, particularly their balance of payments adjustment. External developments contributing to the debt problems of the LIC's, especially since 1979, included oil price increases, inflation resulting from sharp increases in the prices of food and energy products, changes in monetary policies leading to a slowdown in economic activities in the industrialized countries, a slowing in world demand for LIC's export commodities, and sharp increases in real interest rates in international capital markets.

Domestic developments in many LIC's also worsened their payments problem. Inadequate or insufficient domestic adjustment of inflationary demand increases, rigid exchange rate



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policies, and restrictions on trade and payments pressured domestic demand and led to a cumulative loss of international competitiveness and to current account and overall balance of payments difficulties.

Opinions are sharply divided over what caused the current external debt crisis.

- William R. Cline of the Institute for International Economics estimates that external shocks accounted for a major portion of the debt crisis (*5*, Jan. 7, 1985). The external debt of non-oil developing countries rose by some $500 billion from 1973 to 1982, approximately $260 billion of which may be attributed to the exceptional rise in oil prices during that period. Another $100 billion came from declines in the terms of trade resulting from the global recession of 1981-82, while high real interest rates accounted for another $40 billion debt. Domestic policies also contributed to the dilemma, especially overvalued exchange rates and inadequate domestic interest rates.

- IMF economist Eduardo Weisner attributed the debt problem, particularly in Latin America, largely to internal economic mismanagement (*5*, Jan. 7, 1985). "The world recession and high real rates of interest in international markets aggravated the crisis . . . but I do not believe they created it." Weisner, a former Finance Minister of Colombia who now heads the IMF's Western Hemisphere Department, argues that only the fiscal deficits incurred by most of the major countries in the hemisphere explains the debt crisis. "Although other elements contributed, I have no doubt that the main problem was excessive public--and private--spending which was financed by both easy domestic credit policies and by ample resources from abroad." Fiscal deficits in the three largest countries of the region--Argentina, Brazil, and Mexico--more than doubled; behind these growing fiscal deficits were strong political pressures for higher public spending. These demands could be met so long as external financing permitted total domestic consumption and investment spending to exceed domestic income. But as the world recession worsened and as additional financing from abroad was not accompanied by a corresponding increase in exports or in domestic capital, capital inflows dropped substantially, and the fiscal imbalance became an exchange rate and a debt crisis.

- Bahram Nowzad, Assistant Director, External Finance Division, Exchange and Relations Department, IMF, believes "The principal sources of debt difficulties can be traced to (1) overly ambitious government expenditure programs that have given rise to excessive borrowing, (2) investment of the resources from external borrowing in projects that have had inadequate rates of return, (3) lack of central control and monitoring of the contracting of external debt, and (4) general balance of payments problems (caused by domestic policies or exogenous factors or both) that have reduced the foreign exchange resources available and thus have constrained the ability of certain countries to meet their contractual obligations on their outstanding external debt (*19*)."

## IMF CONDITIONALITY

Conditionality evolved with changed economic circumstances and changed understanding of economic processes and of the links between policy instruments and policy options. In



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1968, the Executive Board of the IMF reviewed and formalized the conditionality that evolved during the fifties through the midsixties. About this time, the pressure on the international economy and on the entire Bretton Woods par value system mounted. After a succession of foreign exchange market crises, fixed exchange rates ceased in 1971 and were abandoned by the major industrialized countries by early 1973.

New blends of adjustment and finance were needed, so the IMF established temporary arrangements to provide financing linked to some conditionality. [4] As of April 30, 1985, 15 countries of Sub-Saharan Africa had IMF-sponsored adjustment programs. [5]

Conditionality was further modified because the payments imbalances were perceived to be structural, and unlikely to be corrected over a short time. The IMF believed that adjustment would require extensive changes in the LIC's economies, especially for the oil-importing LIC's, so restoring their balance of payments would not jeopardize their development and growth over the medium to long term (*4*). The imbalances requiring the adjustment originated from an expanded aggregate demand, with a relatively stable aggregate supply. Excessive public spending often fueled the expansion in aggregate demand; corrective action should therefore include measures to raise revenue by restraining government spending. These measures will directly affect public borrowing and the need for domestic bank financing. This link between monetary flows, public spending, and aggregate demand makes monetary policy a key element of demand management and stabilization policies. But the IMF recognizes that authorities in many economies cannot control the total money supply, and so monetary policy is formulated in terms of domestic credit expansion.

IMF-supported programs emphasize a number of major economic variables, especially financial aggregates such as domestic credit, public financing, and external debt, as well as key elements of the price system, including the exchange rate, interest rates, and the prices of commodities that bear significantly on public finances and foreign trade.

A program includes a combination of policies aimed at containing demand expansion (demand management), increasing efficiency, establishing a realistic rate of exchange, and creating the conditions to stimulate output growth. (These also ensure that the revolving nature of IMF resources is maintained.) However, supply management and the structural problems in member countries require greater attention. Supply management (increasing supply through increased efficiency) is supplementing the demand management emphasis of the early eighties to resolve the structural problems of the LIC's. The success of an adjustment program increasingly depends on eliciting an adequate response from the supply side of the economy because of the nature and magnitude of the LIC's payments problems.

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[4] Examples are the Oil Facility, set up in 1974 to help finance payment gaps associated with oil import price rises, and the Trust Fund established in 1976 to provide highly concessional loans to LIC's seeking to adjust to world economic disturbances.

[5] Ghana, Ivory Coast, Kenya, Liberia, Madagascar, Mali, Mauritius, Niger, Senegal, Sierra Leone, Somalia, Sudan, Togo, Zaire, and Zambia (*12*).



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Increased efficiency can be achieved by correcting prices: eliminating consumer subsidies, increasing producer prices, raising interest rates, eliminating government intervention, and increasing the role of free enterprise. Macroeconomic variables such as interest and exchange rates bear directly on savings and investment opportunities and on overall economic growth. Devaluation lowers the adjustment burden that would have to be ensured by demand management measures because the rise in the domestic value of exports should stimulate production and sale abroad and offset the contraction. In addition to these stabilization programs, adjustment also requires trade liberalization to enhance international competitiveness.

The structural nature of the adjustment involved in the programs makes it essential for the IMF to work more closely with development financing organizations, above all, the World Bank, ensuring that IMF-supported policies are compatible with investment programs aimed at overcoming structural deficiencies (often the basic cause of members' payments difficulties). However, conditionality has provoked a sharp controversy on the logic underlying the policies and programs the IMF supports. One view is that payments problems are essentially short term, and should be alleviated by using exchange rate adjustments as well as traditional demand management techniques of fiscal and monetary policy. Another advocates restructuring the economy for sustained stability. Among those who emphasize structural change, two further distinct schools can be identified.

The New Orthodox school is often part of a total economic strategy designed to move the economy in a laissez-faire direction. Demand management, relying heavily on the monetary instruments rather than fiscal ones, is supplemented by trade and exchange rate reforms. The Structuralist/Populist school avoids the traditional demand-management instruments and relies instead on foreign exchange and trade control. Payment problems result from resource immobility (because of factors like land tenure rigidity), market segmentation (for example, different markets for labor and capital), and imbalances between sectoral demands and supplies, which impedes the supply of foreign exchange, intermediate inputs, domestic savings, or food production. Structural and institutional changes do not supplement conventional demand-management policies. Rather, they are supplemented in the short run by price and import controls designed to contain the immediate problem while the longer term restructuring is achieved.

Conventional stabilization programs seek to restore the economy to a course from which it has been jolted. The payments imbalance threatens progress toward other goals, and stabilization is likely to be accorded high priority, with the primary emphasis on demand restraint. Although structural adjustment under the New Orthodox and Structuralist/Populist responses is accorded top priority to sustain stability, "structure" means different characteristics of an economy to these two schools, resulting in differences in policy prescriptions (*8*).

Implications of the differing priorities attached to structural adjustment and demand management in the three types of policy response are analyzed below.

## Conventional Responses

The appropriateness of the conventional demand-management approach as a corrective measure of the balance of payments problem has been questioned on grounds of its excessive costs relative to benefits in LIC's. Recognition of the basic structural features of LIC's and the



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impact of external factors on their balance of payments in recent years has also prompted questions about conventional stabilization policies in LIC's. Therefore, a more flexible, longer run adjustment than suggested in the conventional approach is needed.

The ability of countries to make adjustments is proportional to their level of development. The characteristics of underdeveloped economies (such as imperfect resource mobility and relatively inelastic foreign trade) harshen the instruments of demand management, causing possible declines in economic activities which may prove too costly relative to the benefits to be expected (*19*).

Even when the payments imbalance results from excess demand (as suggested by the IMF), conventional responses to budget deficit reduction and credit contraction may involve a larger decline in output in LIC's than in industrialized economies. The built-in stabilizers of taxes and transfer payments in industrialized economies make fiscal deficits counter-cyclical, and make adjustment relatively smoother. Such mechanisms of built-in stabilizers are not prevalent in most LIC's, thus corrective instruments have a more active role to play (*19*).

Reducing fiscal deficits via revenue increases is difficult because of the low level of income and low tax base--inherent features of LIC's. Revenue-enhancing changes in the tax structure are equally difficult because of inadequate administration in developing countries, especially in the short term. Reducing expenditures may be the only option, but will be economically and politically more disruptive in LIC's than in industrialized economies. Development projects can often be cut more easily, thereby adversely affecting the growth rate of the economy in the long run. The scope for reducing fiscal deficits by conventional methods is thus limited in LIC's even when domestic policies of excessive spending financed by credit and money supply expansion cause the imbalance. The costs might exceed the benefits (*19*).

Moreover, conventional instruments of controlling credit and money supply in LIC's are limited because of their rudimentary financial markets. Central bank credit to a government depends on the deficit financing of the treasury, while net foreign assets fluctuate with balance of payments. As such, of the three components of the monetary base, only central bank credit to commercial banks is normally used to control credit and money supply. This instrument, however, is more effective in monetary expansion than contraction. Hence, the potential instruments of monetary policy in LIC's are limited to variable reserve ratios, open market operations, interest rates, and direct control on bank credit (normally a ceiling). Of these, only the variable reserve requirement and direct ceilings are mostly used, the scope for other instruments being limited. For example, official interest rates are normally fixed by government in most LIC's, and are not used as a monetary instrument. The unsophisticated nature of the organized capital market limits the scope for open market operations. Further, large short-term variations in the money multiplier in LIC's increase the difficulty of controlling monetary aggregates (*19*).

Because external factors such as a fall in world demand for exports, rise in import prices, and high interest rates in industrialized countries were partly responsible for most financial imbalances in LIC's, adjustment by demand restraint alone is a high-cost strategy (*19*).

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### The New Orthodox Program

The New Orthodox program attempts to redress the limitations of the traditional approach. This program attempts to improve the potential scope of conventional demand-management instruments, especially the monetary instruments. Monetary policy, rather than fiscal policy, is emphasized in the short run. In the long run, the New Orthodox program will reduce the size of the public sector, increase the efficiency of product and factor markets, and open the economy to foreign capital and trade (*19*). Instruments such as price control, rationing, and trade and foreign exchange controls tend to be excluded. Public sector investment is also excluded, a free-market economy is more efficient than an interventionist economy.

### The Structuralist/Populist School

The structuralist response to the New Orthodox program questions the efficacy of these instruments and the appropriateness in developing countries of neoclassical theory from which these instruments derive. The Structuralist/Populist school emphasizes the basic structural features of the supply side of the economy rather than the demand side which produced inflation and financial imbalances in LIC's. Imbalances in developing countries originate in the pressures exerted by the growth process on their economic structures. Unlike in an industrialized economy, price signals do not effectively result in needed supply responses because of market imperfections. Institutional rigidities and resource immobility cause bottlenecks in the supply of food, intermediate inputs, and foreign exchange, thereby creating inflationary cycles. Instead of relying on monetary policies, economic policies should be designed to prevent such supply bottlenecks (*8*).

The Structuralist school did not succeed in the fifties and sixties in developing an alternative to the New Orthodoxy for shortrun external debt problems of LIC's. Some "New Structuralists" are developing a structuralist macroeconomics paradigm. However, the school fails to address the problems of the eighties, particularly for critical situations like those in Sub-Saharan Africa.

Because they lack an alternative shortrun program, the New Structuralists question the efficiency and cost-effectiveness of Orthodox programs of stabilization and have suggested a "real economy" approach.

## THE "REAL ECONOMY" APPROACH OF THE STRUCTURALIST SCHOOL VERSUS THE NEW ORTHODOXY

The "real economy" strategy by a group of economists, an alternative to the IMF program, addresses the "structural" aspects of balance of payment problems. This group, however, does not suggest that the IMF switch from a standard demand-management approach to a standard real economy approach; they agree that demand management is essential (*7*). They recommend that the IMF should instead more richly mix policies, recognizing the mutual interdependence of demand- and supply-oriented policies and the basic causes that sparked the problem. This "real economy" strategy emphasizes supply-side measures, in contrast to the IMF approach which emphasizes control of aggregate demand. This approach is likely cost-efficient because such a strategy emphasizes economic growth.



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Output in this strategy grows from improved and increased production. Production expands from increasing output through a more balanced strategy of stabilization: increasing investment (and price incentives), facilitating structural change, and promoting higher employment and faster economic growth.

The IMF recently sought a greater mix of demand-management and supply-oriented measures in its programs. However, the IMF still concentrates largely on demand restraint. These ideas, nevertheless, influenced both the 1979 revision of the guidelines on IMF conditionality and the World Bank's relatively new program of structural adjustment lending (SAL).

How long should the adjustment last? The 1979 revision in IMF conditionality guidelines not only urged more balance in the approach, but suggested medium-term adjustment programs lasting 3 to 5 years. Nevertheless, the IMF currently uses short-term resources (1-year stabilization programs), leaving little opportunity for supply-side policies to be integrated into the monetary model and achieve balanced growth (*3*).

This strategy agrees that active exchange rate policies are needed in LIC's. Against policies of exchange control in many LIC's, tnis group (like the IMF) prefers less direct foreign exchange control because active use of exchange rates is a more positive (and perhaps a more progressive) alternative to severe demand repression. There is general agreement with the IMF on interest rate policies:

> Interest rate reforms that create positive (or less negative) real interest rates are likely to have a number of advantages: They will tend to encourage domestic savings and inflows (or reduced outflows) of capital from the rest of the world; they will tend to channel available investment resources into higher productivity employments. They may, by increasing the demand for money and money substitutes, reduce the necessary degree of credit restraint and employment; and they are likely to enhance the effectiveness of the conventional instruments of demand management, particularly by increasing central bank control over the money base (*27*).

The New Orthodox and the Structuralist schools agree that both external factors and inappropriate domestic policy play important roles but differ in the degrees of importance. They also agree that demand constraint is important in the short run, but the longrun development is important to resolve the problem in the medium term. Relative interest rates are important; hence the exchange rate change or devaluation, other prices, and incentives structures help develop and stabilize these economies.

The nature of the central "structural" problems to be dealt with is at issue more than whether the source of the debt problem (and general economic stagnation) lies in excess demand or stagnant supply (this issue is hardly debated by the IMF or the structuralists) (*2*).

The IMF emphasizes "excess demand" as the cause, but this must be interpreted as a relative concept in relation to supply, especially in the medium term. For the LIC's to achieve a high rate of output growth and achieve economic stabilization in the medium term (by 1990), structural features to be removed or improved upon must be identified. This issue is critical for Sub-Saharan African economies. While some Asian economies are expanding, many Latin American economies remain depressed, and most Sub-Saharan African economies are unlikely to achieve a higher growth rate in this decade.

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## INSTRUMENTS OF IMF CONDITIONALITY

This section considers the instruments used in the IMF program to achieve economic stabilization in LIC's. The impact of the entire package of instruments would be different from that of individual instruments or policies on the balance of payments problem of the LIC's; yet, the ramification of each instrument must also be understood in order to predict the possible outcome of the entire package of instruments and policies of conditionality.

### Balance of Payments

The monetary approach to the balance of payments as advocated by the IMF in the eighties is based on the accounting framework provided by the changes in the quantity of money and the sum of changes in net international reserves and domestic credit. Financial programming practiced by the IMF is based on the relation between demand for money and the sources of creation of money, both domestic and foreign. The balance of payments is considered a monetary variable, and its imbalance can be corrected by adjustment (achieving a viable relationship between aggregate income and aggregate expenditure), reflected in the current account of the balance of payments.

An external imbalance shows a rise in the current account deficit, requiring increased external borrowing to finance the imbalance. The size of this deficit (excess of expenditure over income) is usually determined by the available foreign reserves, credits, and grants. However, such foreign financing depends on the quality of domestic policies pursued: foreigners will finance if domestic policies are adequate or appropriate, but inadequacies will hinder financing (*11*). Thus, domestic financial policies advocated by the IMF, including fiscal and credit measures, should relax the foreign financing constraint, and also narrow the gap between domestic income and expenditure.

In addition to domestic fiscal and credit measures, IMF programs include several economy-wide prices, having ramifications for the entire economy. Adequate pricing, including appropriate exchange rates, interest rates, and administered prices, has been a focal point of IMF conditionality because these prices directly affect aggregate demand, the efficiency of existing resources, and the availability of resources through savings and investment.

Inappropriate prices or price distortions in the IMF approach aggravate the domestic and external imbalances, and reduce potential income. Increased openness of most LIC's to world financial markets affects the magnitude of capital flows; inappropriate macroeconomic variables such as wrong exchange rates and interest rates may discourage foreign financing (*11*). As such, these economy-wide prices are instruments for achieving the demand- and supply-management objectives of the IMF and form a focal point of policies. Using these instruments, known as "getting the prices right," reflects a monetary approach to balancing the payments of LIC's by resorting to the market mechanism or a free-enterprise system.

### Exchange Rate and Devaluation

Exchange rate depreciation (devaluation), an integral part of the IMF's stabilization program, improves the balance between supply and demand in an economy, thereby moderating inflation and strengthening the balance of payments.



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The IMF's underlying premise for such policies has been that most LIC's seeking financial help have an overvalued exchange rate. This overvaluation is attributed to a higher rate of inflation in the LIC's than in their major trading partner or partners:

> A typical example is the small developing country with a fixed exchange rate that does not influence world prices either in its exports or its imports and whose capital markets are rudimentary. Inflationary pressures usually arise from internal political expectations for expenditures or social programs, development projects, or defense, which are higher than can be financed from taxation and voluntary private savings. To finance this increase in expenditures, the government will need to borrow from the banking system. Excessive credit may also have been extended to the private sector which finds it difficult to raise equity in the financial market (*16*).

This expansionary monetary policy increases aggregate demand in the face of a relatively stable supply and increases prices of nontraded goods, such as nonexport agricultural output, intermediate products (raw materials), and prices in the service and construction industries. This inflation, along with resulting decreases in real interest rates, discourages savings and increases wage rates. The prices of tradeables (export and import substitutes) determined in world markets decrease relative to domestic commodities because of a high rate of inflation in the economy. This encourages increased domestic consumption of tradeables through higher income (resulting from higher aggregate demand) and the relatively lower price of imports. At the same time, domestic inflation discourages production of exportables. Export prices are set in the world market, whereas domestic inflation raises input prices and eventually makes the production of exports unprofitable.

Increased imports and reduced exports deplete reserves and worsen the external deficit of the country. The IMF contends that the negative real interest rate resulting from high inflation reduces savings in domestic currency and encourages savings in foreign currencies (because of higher interest rates and higher appreciation). The domestic currency and real interest rates should therefore appreciate.

The IMF approach has little scope for other alternative solutions, given this diagnosis for the current account deficits in LIC's. For example, conventional theories may address the problem by resorting to currency controls, import tariff barriers, and allocating foreign exchange to preferred imports. The IMF objects to these solutions because import restrictions accelerate the inflationary pressures by creating shortages of imported consumption and intermediate goods. Causes of high inflation and exchange rate appreciation (for example, high aggregate demand resulting from excessive expenditure) are not addressed in this approach; nothing encourages the export of tradeables, so measures adopted by many LIC's will probably worsen their balance of payments situation.

Demand management uses financial policies to reduce aggregate demand for goods and services to a level consistent with the country's income. Government spending and credit to the private sector should be reduced until wages and prices are reduced. Demand management decreases costs of producing tradeables and improves their relative profitability (because their prices in the export market remain constant, whereas commodity prices for domestic-consumption goods decrease because of reduced demand). However, the IMF recognizes

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that given downward nonflexible nominal wages, the reduced aggregate demand causes higher unemployment rates in most LIC's and entails a high social cost. Therefore, the IMF advocates devaluation as a less costly solution.

**Devaluation and Trade Balance--A Small Country Case**

The theoretical part of IMF-supported devaluation rests on the special case of a small country--in which a country's devaluation has no effect on world prices, in foreign currencies, and of its exports and imports--perhaps because the country's trade represents too small a share of world trade to change the world price at which world demand and supply are equal.

In this case, devaluation likely will improve the trade balance, lending stability to the foreign exchange market. If the small country cannot change the foreign prices of either imports or exports, only changes in volumes change the trade balance (*10*). Devaluation increases the prices of tradeables and expands their output, lowers the prices of nontradeables, and thus contracts their output. Import demand decreases because of higher prices of tradeables. Export supply increases, and demand for nontradeable goods increases. Devaluation thus brings shifts in demand and supply by changing relative prices between tradeable and nontradeable commodities.

The IMF approach recognizes that this change in relative prices must be relatively permanent if a devaluation is to succeed in shifting resources from nontradeable to tradeable commodity production. Domestic production costs must not increase to the point where they erode the profitability of tradeables resulting from a devaluation. (Such a cost increase is not expected in the IMF approach anyway, because devaluation contracts aggregate demand in the short run, and restrains the upward pressure on prices.) Increased prices of tradeables reduce the real value of cash balances that people are accustomed to hold. Devaluation thus results in a reduced real money supply, and in the need to restore the real value of their cash balances when people spend less. Therefore, demand for all commodities, including tradeables, declines. This contraction rectifies the initial imbalance resulting from excess domestic expenditure over output. If aggregate demand is kept in check, prices are not likely to rise beyond the initial increase from the higher prices of tradeables.

Nonetheless, the IMF approach contends that the decreased supply of and increased demand for nontradeables will increase their prices again, unless fiscal and monetary policies reduce aggregate demand (part of demand management) or unless changed expectations lead to less consumption and increased investment. Moreover, if domestic inflation continues at a higher rate than that of the major trading partners of a country, such inflation will increase the relative price of nontradeable goods, which then offsets the initial price change and thwarts the switching of demand from tradeables to nontradeables, and of supply in the reverse direction. The exchange rate will again be overvalued, leading to an inflation-devaluation spiral. Therefore, devaluation in the IMF program must be accompanied by reduced domestic expenditure and by demand management so that fiscal and monetary policies can reduce inflation by reducing aggregate demand.



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**Complexities Involved in Determining the Probable Effect of Devaluation on LIC's Balance of Payments**

The complexities involved in predicting effects of devaluation on LIC's balance of payments may be highlighted by examining some of the basic assumptions underlying the IMF approach: small LIC's face perfectly elastic supply and export demand functions, current account deficits of LIC's resulted from their expansionary fiscal policies, exchange and trade controls do not exist in LIC's, and the LIC's will implement all the IMF recommendations.

**A typical small LIC is likely to face (at least in the long run) perfectly elastic import supply and export demand functions,** as shown by curves $S_m$ and $D_x$, respectively, in figure 1 (based on *10*). Maintaining the same world prices after devaluing the small country's currency means that importers face higher import prices (by the percentage of the devaluation), shown as a shift in the slope of the domestic demand curve for imports, $D_m$. The importers would buy lower quantities in response to what looks to them like higher prices. The quantity imported would decrease from $Q_1$ to $Q_2$. On the export side, they would respond by exporting more at a higher foreign price. Quantity exported would go up from $Q_1$ to $Q_2$. With export volume rising, and import volume falling at fixed prices, devaluation would improve the balance of trade in goods and services if the elasticity of exports exceeds the elasticity of imports of the LIC. Figure 1 illustrates that devaluation improves the trade balance, in this case from a deficit to a surplus. An increase in the exchange rate from R to R' leads to a foreign exchange surplus of $F_3 - F_1$ from an initial deficit of $F_4 - F_2$.

Net results depend on elasticities of demand. The more exports respond to the given change in the LIC price of exports, the greater the likely improvement in export earnings. The more elastic import demand is in response to the rising dollar price of imports, the more devaluation will cut the total demand to buy imports. Even if we assume infinite supply elasticities of imports and exports, the demand elasticities of imports and exports must at least equal unity for the changes in exchange rate to affect the balance of payments favorably.

The validity of the fundamental assumption underlying the IMF reasoning of perfectly elastic LIC import demand and export supply curves is open to question. The total world demand for the exports of LIC's (mostly primary commodities) is not very responsive to price changes. Given such an inelastic foreign demand curve facing the LIC's for their exports, the supply curve of the small country's foreign exchange will bend backward. With a backward-bending supply curve of foreign exchange, an increased exchange rate reduces the quantity of foreign exchange supplied (fig. 2). In this situation, a rise in the exchange rate of a small country's currency from R to R' would cause the quantity of exchange supplied to decline from $F_2$ to $F_1$. This reaction, opposite to that usually expected from devaluation, would worsen the trade balance. In this case, exchange rate variation to adjust the balance of payments is not appropriate.

Even if the total world demand for LIC's exports of some commodities such as semimanufactured products were relatively elastic, devaluation would increase the supply of foreign exchange for one country only if other competitors did not adopt a similar policy. Simultaneous devaluation by a large group of LIC's would not achieve the expected results.



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Figure 1

# Devaluation and trade balance--a small country case

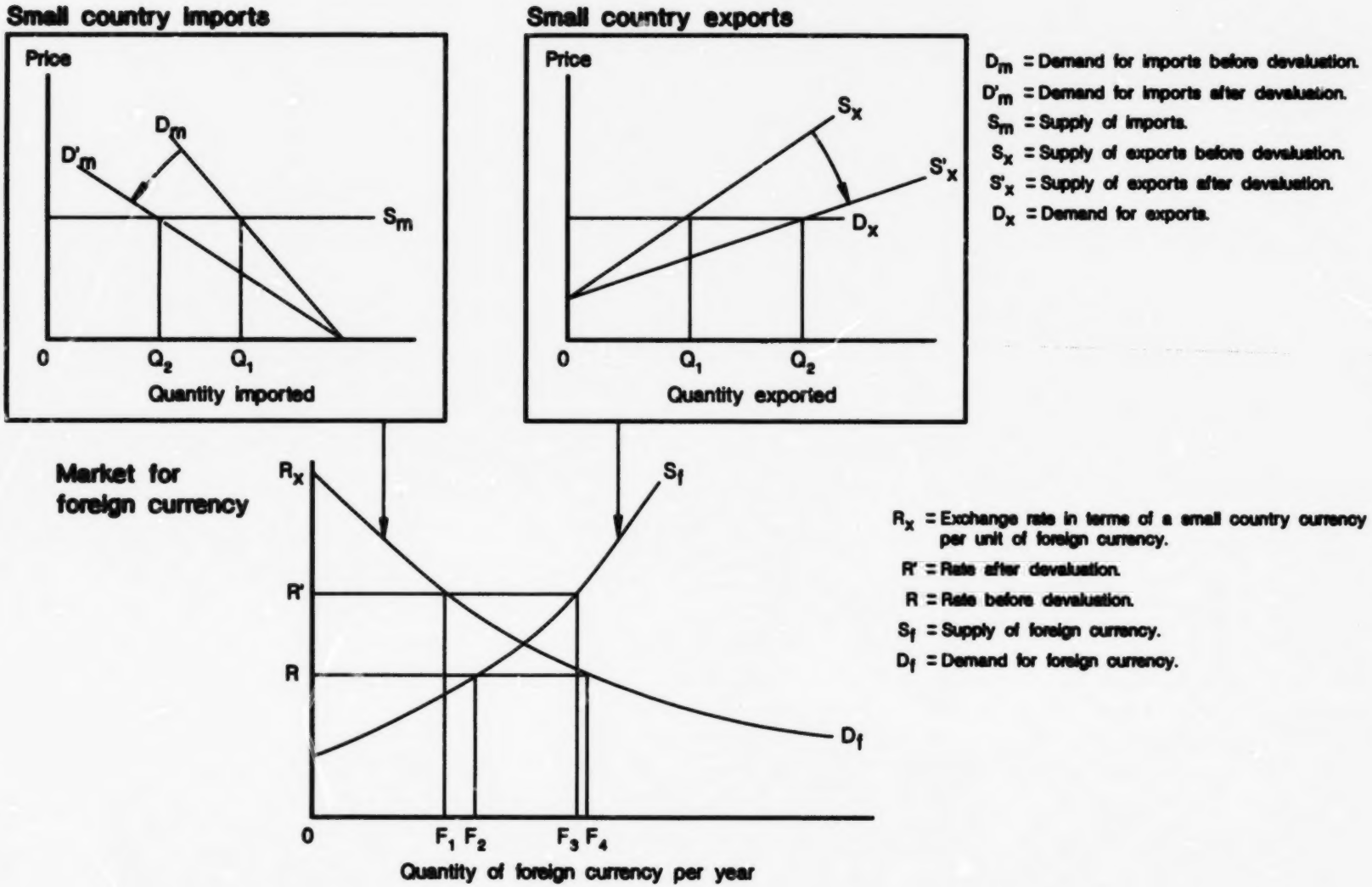




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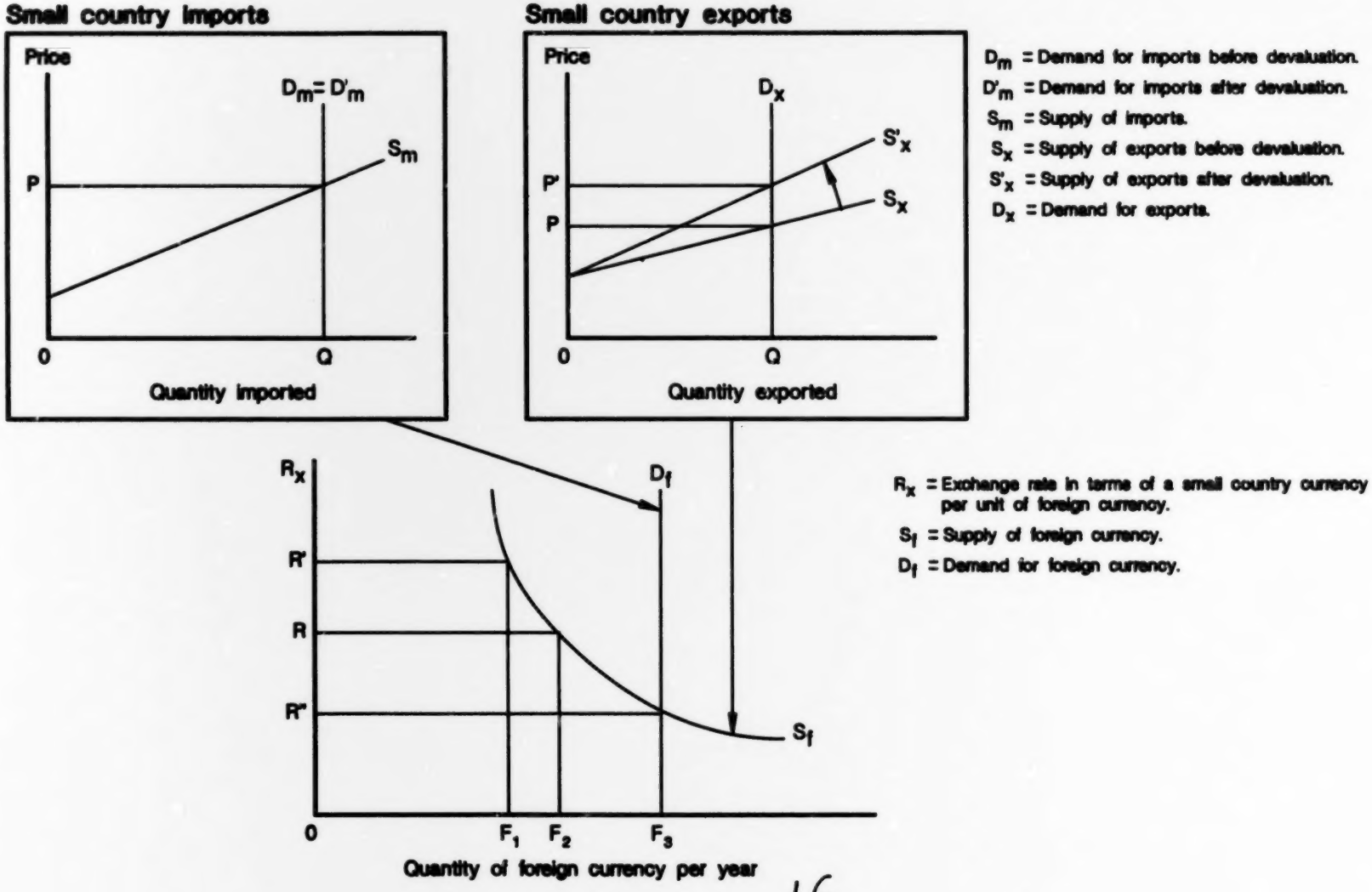
Figure 2

# Devaluation and trade balance--inelastic demand




$D_m$ = Demand for imports before devaluation.
$D'_m$ = Demand for imports after devaluation.
$S_m$ = Supply of imports.
$S_x$ = Supply of exports before devaluation.
$S'_x$ = Supply of exports after devaluation.
$D_x$ = Demand for exports.

$R_x$ = Exchange rate in terms of a small country currency per unit of foreign currency.
$S_f$ = Supply of foreign currency.
$D_f$ = Demand for foreign currency.

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Second, the assumption of an elastic demand curve for the small country's imports may not be valid. LIC's mostly import food, raw materials, and intermediate capital goods, which may not respond to small price changes. Thus, an inelastic import curve and an inelastic foreign demand curve would yield the situation depicted in figure 2 (although the demand curve may not be as inelastic as shown in the graph). In this situation, a revaluation of the currency from R to R" theoretically increases the supply of foreign currency from $F_2$ to $F_3$ and reduces the balance of payments deficit.

The IMF assumes elastic domestic supply curves in the face of devaluation because output should be price-responsive and resources should move freely across sectors in response to devaluation in LIC's. For example, when a country devalues its currency, resources shift to its export- and import-competing sectors to improve the trade balance. Resources are presumably transferred from the sector producing nontraded goods such as subsistence farming, services, and construction. Domestic consumers are also expected to decrease their purchase of exportable goods and import-competing goods and to shift their demand toward the nontraded goods, whose prices have risen less. This can happen in some cases in the short run, and devaluation can increase exports and cut imports. In the medium and long run, however, increased consumer demand for nontraded goods may increase prices in this sector as well, thereby reducing the price differentials among these sectors. Therefore, resource transfers to the traded sector at this point may not take place, and the export supply curve may become inelastic as depicted in figure 2.

Although the assumption of such inelastic export supply and import demand curves as suggested above may be overstated, the trade balance shifts less in the long run than in the short run in response to a devaluation. This happens partly because the nontradeable commodities sector serves as a resource-releasing reservoir in the short run, but not in the medium or long run (*10*).

Fourth, resources in most LIC's are not perfectly mobile so the expected benefits may not materialize, even in the short run. There may be some shortrun effects to agriculture and mining, where a price incentive for exports in the form of a devaluation might benefit within a year. Over many years, more extensive and intensive farming and mining in export products may substantially improve output in the agricultural sector. But without other complementary inputs such as infrastructure, credit, irrigation, and fertilizer, the price incentive alone may not be a strong factor in improving agricultural output.

Fifth, econometrics forms the basis for policy judgments when estimating trade elasticities. The willingness of policymakers to rely on exchange rate and price adjustments to rectify payments imbalances, rather than intervene directly with exchange controls that ration the right to trade, depends on their faith in the demand elasticities, which in turn rest on econometric estimates (*10*).

Many countries earlier resorted to direct exchange controls instead of relying on changes in exchange rates, due to econometric estimates which found low demand elasticities. There has been some guarded optimism during the sixties through eighties stressing that demand elasticities are probably high enough to make devaluation work as it should (*10*). The general consensus now is that the trade-balance response stabilizes (abrupt) changes in exchange rates. Devaluation or depreciation of a currency will likely have a stabilizing



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influence on the trade balance over about a year. This is likely to give speculators a more stabilizing signal than they would have received from the foreign exchange market, so they too would gain faith in the currency as a result of its depreciation. An export elasticity near 1, with respect to the exchange rate, is reasonable in LIC's too, but only over the medium term. Before that, the export response will be weak and devaluation will be stagflationary.

Another criticism is that the price elasticity of export supply is low typically because the aggregate curve for exportable products is S-shaped, having an inelastic portion corresponding to activities such as mining and industrial agriculture, an intermediate segment for food production, and a very elastic segment for industry (*22*). These differing supply elasticities reflect the varying cost structures of the related activities. While the supply curve of the industrial sector is relatively elastic, this sector depends on imported inputs to a greater extent than do other sectors. Devaluation thus tends to increase the profitability of industrial production less than that of primary production. Since the elasticity of mining and agriculture with respect to the exchange rate tends to be low, the aggregate elasticity of exports with respect to devaluation is also low.

Seventh, the potential for increased exports may be more limited than expected since the contraction of world trade in 1981 and since the increased protectionism in the industrialized countries. In addition, when the growth in world demand for some agricultural export commodities is slow or even stagnant, increased market shares of exports by one country can be achieved at the expense of the other. Total world demand for these commodities being fixed or declining, all countries cannot simultaneously increase exports through devaluation.

Eighth, where import compression has occurred prior to devaluation (as in many LIC's) devaluation may not lead to further decline in imports in response to price changes, especially if domestic substitution possibilities are restricted. Also, many countries need to import food, raw materials, capital equipment, and spare parts for maintaining and/or improving export commodity production. The import demand elasticity for these commodities is highly inelastic, so devaluation would aggravate the current account balance even in the short run. Exports must exceed intermediate imports, and the export elasticity that guarantees favorable impact on balance of payments can be less than 1 in many LIC's. Under such conditions, the shortrun current account balance may very well deteriorate following a devaluation.

**The current account deficits of LIC's resulted from their expansionary fiscal policies.** This is a major premise underlying the use of devaluation to rectify such current account deficits. However, a country's current account position may deteriorate for many other reasons, including a deterioration in the terms of trade, price distortions, and higher debt services. All these factors combined in the late seventies and early eighties, creating a current account deficit for many LIC's. Such deficits can be sustained by drawing on reserves of foreign currencies and/or capital inflows.

When the deterioration in the terms of trade is a major reason for current account deficits, devaluation is theoretically not the solution. Devaluation would yield limited success in improving the terms of trade of LIC's, except for reduced imports resulting from a contraction of aggregate demand. For example, devaluation could not have reversed the



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deterioration in terms of trade experienced by many LIC's in the eighties. The terms of trade moved against non-oil exporting Sub-Saharan African countries by 0.4 percent in the seventies. Terms of trade further deteriorated between 1981 and 1982 by 14.5 percent for LIC's and by 13 percent for Sub-Saharan Africa less oil exporters. To offset lowered LIC's export prices from a recession in industrialized countries, rational policy would be to await the upswing in the trade cycle and the improvement in the terms of trade.

The deterioration in terms of trade may also be secular, that is, a long-term decline in market share, where a switch to producing other commodities would be appropriate. However, this entails a waiting period, available foreign reserves to draw on, and/or capital inflow. When the crisis in confidence in the debt-repayment ability of LIC's took place in the late seventies and early eighties, both these sources dried up, so the IMF intervened.

**Exchange and trade controls do not exist in LIC's.** The IMF reasoning does not consider the prevalence of extensive quantitative exchange and trade controls in the official foreign exchange market, probably because the IMF recommends abolishing these restrictions. Some recent theoretical work suggests that devaluation will have a different macroeconomic effect in LIC's, characterized by different quantitative restrictions than in the one assumed by the IMF where these are supposed to have been abolished or are expected to be abolished (*17*, *18*). Instead of having an inflationary pressure, LIC's with an exchange control regime may have deflation or contraction as a result of devaluation. If these occur, some of the previously discussed possibilities will be ruled out.

The differing macroeconomic effects can be explained by referring to a model for an economy with dual exchange rates. Such regimes have become a common feature of the international monetary system since the fifties. Conceived to insulate from large and potentially volatile capital flows, this dual arrangement has an official and a financial market for capital transactions. Current transactions are conducted in the official market at a managed or fixed rate, yet the exchange rate is freely determined in the financial market. Although quantitative controls would keep these two markets separate, such quantitative restrictions on current payments in the official market are practically nonexistent.

But the dual exchange rate system prevalent in most LIC's has quantitative exchange and trade controls in the official market. These controls were designed to protect depleted reserves and to avoid official exchange rate adjustments when the balance of payments is pressured. Mechanisms, like reserve movements, do not exist to ensure that all prevailing demand for foreign exchange at official rates are met and the market is cleared. Without deterrents (prohibitive costs), a parallel underground market for illegal foreign exchange transactions develops where the price is much higher; the domestic cost of imports is reflected in the foreign exchange rate prevailing in this market. Changes in the demand for and the supply of foreign exchange in the official market directly affects the parallel market rate, thereby reflecting changes in the official exchange rate or in import and exchange restrictions.

The presumed benefit of the LIC's systems which follow expansionary economic policies, that it helps contain inflationary pressures in the short run, is incorrect. In this new model, which shows that this type of regime does not lead to inflation, domestic prices will most likely reflect the price of foreign exchange in the parallel market rather than the official



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exchange rate. A more depreciated black-market rate incites domestic exporters to conduct some of their transactions through illegal channels. At the same time, imports above the officially approved levels will also be purchased illegally as long as the higher cost can be passed along to consumers. Thus, by the time the government devalues the official rate, domestic prices will already reflect the higher cost of foreign exchange, and the devaluation will have no further inflationary effect.

A devaluation can sometimes have a deflationary effect in countries with dual exchange rate systems of the type discussed. There may be an inverse relationship between movements in the official and black-market rates. Thus, if market participants expect a devaluation of the official rate, the demand for foreign exchange through the black market will decline immediately, leading to a temporary appreciation of the domestic currency on the parallel market (and with domestic import prices reflecting the parallel rate) to a lower price level (17, 18).

Even an unanticipated devaluation can exert downward pressure on the domestic price level if the devaluation leads to a surge in domestic output that increases the demand for the local currency. A part of the domestic exports is diverted to the black market with a depreciated exchange rate. A good import market also normally flourishes for commodities with a market demand high enough to justify the higher cost that resulted from a higher foreign exchange price in this market. By the time the devaluation to the official exchange rate takes place, domestic prices will already reflect the higher cost of foreign exchange, and the devaluation will have no further inflationary effect. If further steps are taken toward demand management, using devaluation to restore the balance of payments viability would be an overkill. The IMF however recommends abolishing the trade and exchange controls.

**The LIC's will implement all IMF recommendations,** including abolishing price controls and import restrictions, to ensure that devaluation resolves the external financial problems caused by increased exports and reduced imports. In countries where price controls, import restrictions, and administered decisions on production are prevalent, modifying these are necessary for achieving the objectives of devaluation. Restrictions on inputs for export commodities must be relaxed. In state enterprises such as state farms, administratively determined cropping patterns may have to be abandoned in favor of cropping patterns determined by market forces. Market mechanisms must replace the functioning of a mixed economy for devaluation to be successful. Many LIC's find it politically and economically infeasible to do so, so devaluation's role in reducing the external balance gap may be limited, even negative.

At best, devaluation may improve the current account deficits of some countries moderately in the short term; at worst, it might overkill and lead to great social costs without improving the trade balance. In most cases, it might also lead to an inflation-devaluation inflation cycle. There is, therefore, a need for greater emphasis on country-specific situations than is given in the IMF-advocated monetary theory of balance of payments.

### Interest Rates

The IMF states that exchange rate and interest rate policies cannot be separated, and must be pursued concurrently to achieve and maintain an external equilibrium. In a world of increasing economic sophistication and growing financial interdependence, interest rate policies affect aggregate demand and capital flows by influencing the domestic savings investment process, and also through the international capital flow process.

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In many LIC's, interest rates in the official money market are often controlled through credit restrictions (as opposed to rediscounting and open market operations) as a counterpart to central bank regulation of the banking system. Rediscounting and open market operations often are not effective in many LIC's because their economies often have unsophisticated financial markets. Many LIC's have also imposed a ceiling on official interest rates and rationing of credit. Recent fixed interest rates in many of these economies have often been negative in real terms; that is, the nominal rates less the observed rate of inflation is less than zero (*24*). Although such negative interest rates were also prevalent in many industrialized countries, especially during high inflation, this phenomenon has been discussed more frequently with respect to the IMF and the LIC's.

The interest rate ceiling and credit rationing are called financial repression, and such nonmarket allocating of financial resources is considered inefficient. Such interest rates reduce the supply of funds through the organized financial markets and lead to lower investment in the economy. A negative interest rate worsens the structural features of LIC's, thereby contributing to their financial imbalances. Savings can only be channeled to productive investment through financial institutions, such as the banking system. Otherwise, such savings are either hoarded or diverted to nonproductive uses, such as purchasing gold and real estate. Interest rates below the level of those prevailing in the rest of the world lead to capital flight to foreign countries, thereby reducing the domestic supply of capital. The IMF thus emphasizes the role of interest rates on domestic savings through financial intermediaries, automatically transforming such savings into investment. Some economists disagree in the context of LIC's.

Even if savings respond to bank interest rates and if investment is interest-elastic in LIC's, there are other pertinent questions to be considered. There are informal financial markets in most LIC's, and the interest rates prevailing in these markets are important. Producers in the agricultural and industrial sectors in most LIC's significantly use these informal financial markets. The village credit markets are generally efficient and are designed to meet the special credit needs of the small producers, although the interest rates charged are relatively high. A higher interest rate in the official market will increase bank deposits at the expense of this informal lending, although some assets such as gold and real estate will be converted into bank deposits. Nonproductive assets, when converted to productive ones, can increase investment. On the other hand, credit for the small producers might contract because of their restricted access to the organized banking system. This capital shortage might lead to a cost-push, decline in investment demand, and economic contraction or stagflation (*24*). These may also adversely affect foreign trade and balance of payments.

If interest rates are raised above those prevailing in the world market, domestic and foreign investors will lend to increase their holding of domestic financial assets. Local entrepreneurs will tend to borrow from abroad to meet their credit needs. This may result in substantial capital inflow if interest rates are unrestricted and in exchange rate appreciation, contradicting the devaluation poliqy pursued by the country governments and the IMF programs. Changes in the capital movements and current account may destabilize the foreign-asset component of the monetary base, making the market's monetary control less effective (*24*).



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It is not possible to deduce which outcome is more likely; much depends on specific circumstances of a country. Because of the structural features of the financial markets in many LIC's, IMF attempts to improve the external financial problems of LIC's by correcting interest rates may prove less effective than expected, and may even have some adverse effects. However, interest rate ceilings in most LIC's have not achieved the stated objective. The larger and more influential farms in the agricultural sector received most of the low-interest credit (*13*). However, changing their interest rate policy from that perspective may not significantly affect the current account deficits.

### Monetary Contraction

In addition to the exchange rate and interest rate policies, the IMF believes the LIC's excessive monetary expansion caused the external imbalance. This monetary expansion produces changes in relative prices, thereby encouraging imports, discouraging exports, and inducing unfavorable capital movements. Monetary expansion does not occur automatically but is promoted by other factors which mainly originate in the public sector. Large fiscal deficits have recently caused excessive monetary expansion in many developing countries.

The monetary approach to adjustment in the balance of payments states that fiscal expansion financed by borrowing from central banks affects international reserves of a country, thereby negatively affecting the balance of payments. The increased money supply, resulting from such borrowing, creates an excess liquidity in the hands of the public. This excess liquidity increases the demand for domestically and foreign-produced goods; it also increases the demand for alternative financial assets, including foreign assets, thereby pressuring the balance of payments. This monetary approach implies that the excess supply of money created by the deficit would be eliminated when foreign exchange reserves have been depleted and an equilibrium in the money market has been restored. In addition, pressure exerted by the excess liquidity on prices would reduce the real value of outstanding money stock and would balance the money market (*23*).

In an open economy (one with a high share of traded goods in total expenditures) with a flexible exchange rate, the exchange rate operates through changes in price level and restores the monetary equilibrium. If the exchange rate is allowed to adjust, the monetization of fiscal deficits will push up the exchange rate, reduce the loss of reserves, and increase the inflationary effects. The impact on international reserves will be small. However, the role of the balance of payments under a fixed exchange rate system will be more significant so that loss of reserves would be larger, and the effects of monetized deficits on domestic inflation would be smaller.

The IMF recommends adopting a monetary contraction policy. The ability of the banking system to expand lending through changes in reserve requirements or other restrictions should be curbed to reduce the effects of the central bank's expanding domestic credit to finance public sector deficits. These restrictions may limit the credit available to the public sector as well and,to the extent interest rates are market-determined, may increase interest rates. The IMF program mandates ceilings on credit to the government with a subceiling for the private sector to overcome any constraints on private-sector financing while monetary contraction is implemented. Otherwise, the private sector might be excluded from the credit market, and the stabilization program would cause a sharp fall in economic activity (*23*).

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Monetary restrictions thus take the form of ceilings on credit to the government and private sector. Such restrictions on domestic borrowing from the banking system are supposed to improve the balance of payments.

However, tight money pushes up interest rates on loans for working capital for investment, thereby increasing investment costs. At a higher cost, investment would go down, lowering aggregate supply, which would also lower aggregate demand later on. Excess demand for commodities may then accelerate the inflationary pressures. Thus, monetary contraction may contribute to stagflation in the short term, increasing prices and leading to output contraction through the interest rate cost-push (*24*).

**Subsidy Policy**

The IMF contends administered prices have as pervasive an impact as exchange and interest rates. Producer prices for many export products are frequently subject to the control of the authorities, and therefore, can markedly affect macroeconomic equilibrium.

Consumer subsidies on importable commodities, especially food, are a common feature of price policy intervention in most LIC's. Such intervention keeps food prices cushioned off from world prices and lowers the domestic prices of food for consumers, especially the urban poor. Food prices are often directly linked to inflation in LIC's, and also determine the real wage rate. Lower food prices are sought so LIC's can industrialize with a low real wage rate and a low rate of inflation.

The IMF-supported programs call for abolishing most food subsidies because subsidies are paid by the government, pressure the budget, and thus adversely affect the balance of payments in the short run. The IMF contends that subsidizing food imports causes the domestic price of such food, for both consumers and producers, to be lower than the world prices. As a result, the quantity of food produced domestically declines, the amount consumed locally increases, and rice imports are greater than before the subsidy was given (fig. 3 depicts a static model of rice imports).

$P_2$ in figure 3 shows the world price, which equals the domestic price of rice in the importing LIC before the subsidy is administered. The quantity demanded is $Q_3$ and supplied domestically is $Q_1$, and the gap between the two ($Q_1$ - $Q_3$) represents imports. A subsidy decreases the domestic price to $P_1$, which is below the world price. The quantity demanded at this lower price increases to $Q_4$, but the quantity supplied by domestic production goes down to $Q_2$, thereby increasing the import gap ($Q_4$ - $Q_2$). The government subsidizes all imported rice, because the world price at which the food is imported is higher than the domestic price. The total subsidy (per-unit subsidy times the total quantity imported) is the area in the rectangle JMPO. The producers pay a subsidy to consumers because of the lower price the producers received. This income transfer to consumers (the unit subsidy times the total produced) is the rectangle IJON plus the profit loss from output reduction in the triangle JKO. The IMF contends that the subsidies paid by producers discourage production in a dynamic model, and have an adverse effect on the balance of payments that is somewhat more delayed.

Therefore, the IMF program calls for abolishing subsidies on imported food, which raise the domestic price of these imports to the level of world prices. Doing so would reduce budget deficits and provide an incentive--higher prices--for increased output.



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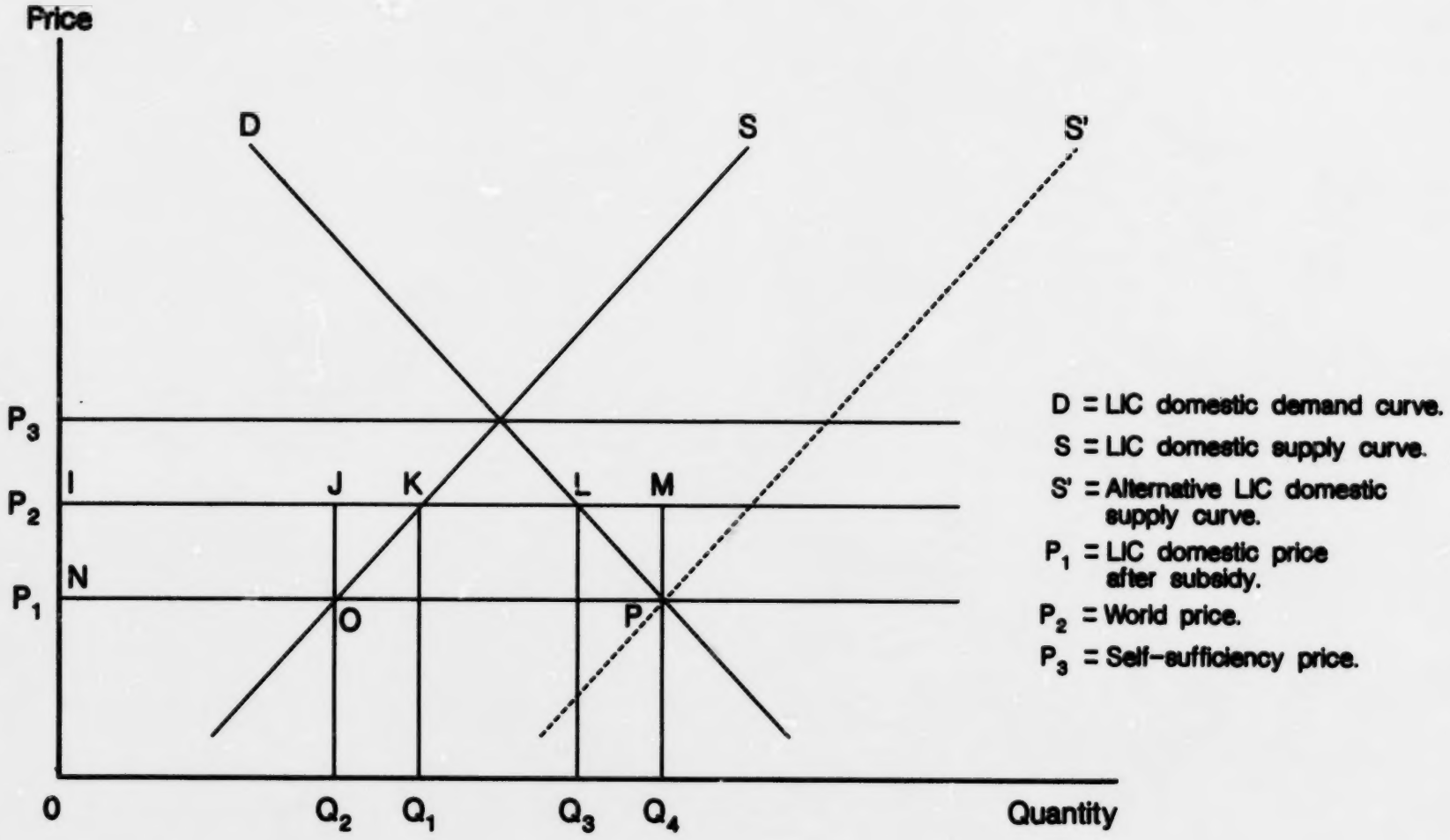
Figure 3

# Effects of a consumer subsidy on import price of rice

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Abolishing subsidies and raising the price to $P_2$ would reduce the quantity demanded of food at that price from $Q_4$ to $Q_3$ and this, along with an increase in quantity supplied from $Q_2$ to $Q_1$, would reduce imports to the original nonsubsidized level. Such a decrease in quantity demanded reflects the inability of the poor consumers to purchase food at the new market price, not the elimination of their food needs.

There is always a tradeoff between price incentives and the basic human need for food in a poor country. The IMF program seems to weigh more heavily on the price incentives side of this tradeoff.

Also, a policy of raising the price of imported food commodities to $P_2$ may lead to an increased output of those commodities, but the increase might be achieved by diverting crops from exportables to importables. Output of both import and export commodities may be increased only if abolishing subsidies is coordinated with a program for providing inputs such as credit, water, fertilizer, seed, extension services, and supporting infrastructure such as roads and marketing and storage facilities. Such a coordinated policy package encompasses much more than the current IMF stabilization program envisions. Under the current IMF program of abolishing food subsidies and raising the price of imported food to the world price level, the LIC's budget situation may be improved only through lower food consumption, especially by the poor.

Attempts at reducing the current account deficits by abolishing food subsidies may prove to be one of the most difficult policies to implement in most LIC's, as demonstrated by recent food riots in Sudan, Liberia, Egypt, and elsewhere. Combined with other policies in the IMF program, such reduction in food consumption on top of a lower aggregate demand might prove politically and economically infeasible in most LIC's. Moreover, higher food prices resulting from abolished food subsidies will accelerate the inflationary pressure and increase the real wage rate, both of which weaken economic activities of these countries.

Overemphasis on pricing policies alone may lead to drastic policy recommendations to push the LIC's domestic price to $P_3$, above the world price, as a possible device for achieving food self-sufficiency. Such self-sufficiency at price $P_3$ would be achieved by reducing food consumption in poor nations and also perhaps by displacing the production of other important agricultural commodities (*25*).

What, then, is the alternative? First, a new policy abolishing subsidies for the rich, while possibly retaining them in the short term for the poor. Second, since the cost of food production can be maintained in many LIC's at a lower level than the cost of production of their major trading partners, food self-sufficiency may be achieved even at $P_1$ (the LIC in a dynamic model domestic price after a subsidy), if the LIC's supply curve can be shifted in the medium term to S' through low-cost technology. The farm management data from India as well as the Indian and Chinese experience of achieving food self-sufficiency through labor-intens e low-cost technology on small-scale farms demonstrates the feasibility of such an approach under diverse political environments.

Tropical Sub-Saharan Africa is now the critical region in this respect. Yet Zimbabwe, Malawi, and other countries show that even in the absence of a green revolution suited to the needs of tropical Africa, food self-sufficiency is possible, provided the necessary inputs are available to farmers. Increased output in the peasant sector of agriculture in Zimbabwe has significantly contributed to its recent self-sufficiency. An appropriate price policy is



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an important ingredient of a good policy package, but should not be overstressed as the single factor. Other agricultural productivity improving methods could achieve self-sufficiency (thereby reducing the import requirement and balance of payments problem) without inflicting hardship on the poor, and risking political upheaval (addressed later in the report).

### Reform of Public Sector Enterprises

The public sector assumed a major responsibility in production and distribution of goods and services under the mixed economies of most LIC's. During early stages of economic development, the private sector could not undertake certain economic functions. In several LIC's such as India, some of these public enterprises were expected to contribute to government revenues out of their profits. In other cases, these enterprises were subsidized to enable them to supply some basic goods and services to the community at reasonable prices to benefit the poor majority. The expectations were not fulfilled in many cases, and these enterprises incurred losses which were borne by the government.

The IMF program calls for drastically reforming these enterprises to make them efficient (judged by the criterion of earning profits). The IMF recognizes that these enterprises should not be judged solely on efficiency grounds, because many provide vital social services. Nevertheless, the IMF argues these enterprises are profit-oriented, and should not perform this role; social services should be specifically provided for in the budget. This policy of reforming or eliminating the public enterprises is to be coupled with privatization, thereby improving the "efficiency." While there can be no argument against improved efficiency, abolishing public enterprises in most LIC's, especially in Sub-Saharan Africa, should be matched with concrete proposals and effective alternatives to replace the functions currently performed by state enterprises. Otherwise, the situation is likely to be more chaotic and wasteful than at present.

### Perspectives

The individual instruments and policies of IMF stabilization form parts of a well-structured, consistent, monetarist approach to the balance of payments. Individual policies have limitations and some possible adverse effects that are difficult to project, such as the effects of devaluation, interest rate changes, monetary contraction, and abolition of food subsidies. If all the policies are used simultaneously and effectively, there is bound to be overkill--adjustment at very high cost. The monetarist approach to the balance of payments is not valid in certain country-specific conditions or some stages in the economic cycle. The IMF sees the monetarist model as a universally valid analytical framework, derived from the balance-sheet identity (*22*). The change in the net international reserve position reflects the difference between changes in money and credit.

The analysis of expected results is much more complex than the clear-cut, balance-sheet identity approach of the IMF. The effect of one policy instrument might become intensified or neutralized by other policy variables. And adjustment programs built on this approach are excessively vulnerable to errors in forecasting. Errors arise because programmed policy measures such as discretionary government revenue measures, changes in exchange rate management or in the interest rate structure, or the removal of exchange restrictions do not yield the expected results.



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The balance-sheet identity version of the monetarist approach to balance of payments elicits differences of opinion. The IMF assumes that markets are perfect and adjust speedily even in LIC's because markets are fully competitive (oligopoly, monopoly, or imperfect competition do not exist to hamper competitive adjustments) and there are no structural imbalances. Even if some of these exist, they are temporary deviations. These assumptions are hardly valid even in industrialized economies, and definitely less valid in LIC's. The model is well-structured and consistent, but assumes that the economies assisted by the IMF are perfect, which is far from the reality. The effect of the needed adjustment variables is so significant and spread over a long time that the objectives are almost impossible to achieve.

If IMF conditionality is carried out, these policies could reduce LIC's economic activities, increase unemployment, aggravate the balance of payments, and induce a series of devaluation-inflation-devaluation cycles. At best, some of the policies might moderately improve the LIC's current account deficit situation, but at the cost of economic contraction. In most cases, however, the overall ramification would be neutral or marginally positive. The external financial and other macroeconomic conditions in LIC's are likely to be influenced more by the international environment, particularly the economic performance of industrialized countries and constraints imposed by official and commercial loans, than by IMF conditionality during the rest of the eighties.[6]

## MACROECONOMY AND TRADE IN LIC's

In 1983 and 1984, the U.S. economy had a strong growth in output, as did Japan, while expansion in Europe kept pace with the estimated rise in production. In 1984 and 1985, this recovery in the industrialized countries' output affected the LIC's balance of payments and economic growth.

### Current Account Deficits

The external debt situation of LIC's has improved dramatically since 1982. Their external deficits reduced to a sustainable level in 1984 that far exceeded the expectations of the IMF. The current account deficits of LIC's, after reaching a record-high $113 billion in 1981, fell to about $38 billion in 1984 (expressed as a share of goods and services, declined from 21 to a record-low 7 percent).

The decline in external deficits has been even greater among countries that mostly borrow from commercial sources, including most of the largest commercial borrowers, whose average deficits are now about 2 percent of exports. For the seven largest borrowers (Argentina, Brazil, Indonesia, Korea, Mexico, the Phillippines, and Venezuela), the combined current account deficits fell from $40 billion in 1982 to only $1.5 billion in 1984. This represents a decline in their imports from 18.5 to 1 percent. The size of this change has surprised many. In 1983, the IMF projected that the LIC's deficits would be $53 billion in 1984, about $15 billion higher than the current estimate.

[6] This is conclusively proved by a number of African case studies. For example, see (*15*).



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## Factors Responsible for the Reduction in Current Account Deficits

An important factor behind the reduced current account deficits of LIC's in 1984 has been the halt of spontaneous private lending since the onset of the debt crisis in 1982 (*6*). LIC's borrowed $130 billion from private institutions in 1981-82, but only $30 billion in 1983-84 ($7 billion of which was outside the restructuring requirements). Such severe external financial constraints drastically altered the external financial situation of LIC's. They increasingly resorted to reserves, IMF credit, and import compression to relieve their debt problems and sustain their economies.

However, the extent of these financial constraints varied, depending on whether countries were market borrowers or official borrowers. The market borrowers (two-thirds or more during 1978-82), comprising 35 countries with relatively high per-capita income, account for half of the LIC's gross domestic product (GDP) and exports of goods and services. Official borrowers consist of 59 mainly primary product exporting and low-income developing countries. While the combined deficit of the market borrowers declined dramatically from $72 billion in 1981 to $8 billion in 1984, that of the official borrowers fell only marginally from $19 billion to $17 billion (app. table 1). The market borrowers' current account deficit was only 2 percent of exports of goods and services, whereas the combined deficit of official borrowers remained close to half of their exports.

Countries that borrowed mostly from official sources rather than the commercial or market sources, did not face such drastically curtailed access to financing after 1982. The shift in their current account positions has been much less severe. The debt-to-exports ratio of these countries continued to increase through 1983. After receding somewhat in 1984, it rose to a new peak of 163 percent in 1985 as a result of renewed weakness of export earnings combined with growing debt. These countries were insulated from the turbulence of the capital markets and unable to borrow from commercial sources at market rates. They have thus maintained a stable current account deficit because official creditors could finance with the available nondebt-creating flows and longrun (mainly concessional) funds. Despite their weak reserve positions, this pattern was projected to continue in 1986.

Differences in the financing situation of market and official borrowers are clear and simple; financing among market borrowers varies according to their debt-servicing problems in 1981-84. Private lending to countries that experienced debt-servicing difficulties declined from $59 billion in 1981 to a mere $3 billion in 1984. Private lending to countries without debt-servicing problems merely reduced from $27 billion to $13 billion.

While the level of net disbursement from official creditors remained fairly stable at about $29 billion per year during 1981-84, the repercussions of the debt crisis significantly affected the direction of the funds. Official creditors increased disbursements to countries experiencing liquidity problems, often as concerted lending packages and rescheduling arrangements. Under these arrangements, official creditors assumed those rescheduled bank loans that they previously guaranteed. This shift raised the market borrowers' share of net official lending from less than 33 percent in 1979-80 to 50 percent in 1983. However, this shift reduced (although not in absolute terms) the official borrowers' share. Within this group, however, net disbursements to the LIC's, including those of Sub-Saharan Africa,

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declined about 15 percent from 1979-80 to 1983-84 (app. tables 1, 2). Official lending to market borrowers remained relatively high in 1985 because of disbursement lags from commitments made in 1982-84 and the continued problems in several Western Hemisphere countries.

Sub-Saharan Africa will probably have difficulty restoring the level of their borrowing from official creditors to the $5 billion annual average rate of 1980-82. This is partly due to official export-credit guarantee agencies' downgrading the credit rating of many countries in the region after the many debt-servicing problems in 1982-84. These agencies are generally cautious about medium-term lending to countries that have rescheduled payment. Some donors have expressed concerns about the efficiency with which some African countries use concessional resources. Any reduction in official trade, credit, and aid flows would immediately and adversely affect the economies of Sub-Saharan Africa: given their inability to raise credit elsewhere, reductions increase the difficulties of sustaining their development programs.

### External Debt

As a counterpart of the net borrowing situation described above, the growth rate of the external debt of LIC's also decelerated, partly because of the appreciation of the U.S. dollar against the currencies of indebted countries. In terms of U.S. dollars, the growth rate of the LIC's debt decreased from an average 19 percent per year in 1977-81 to 5.25 percent annually in 1983-84. About 20 percent of the LIC's total external debt was originally denominated in currencies other than U.S. dollars. Rapid appreciation of the U.S. dollar since 1980 (the effective exchange rate rose by 49 percent from the end of 1980 to the end of 1984) pushed down the U.S. dollar valuation of the non-U.S. dollar component of debt.

The U.S. dollar's appreciation also constrained the increase in world trade prices, reducing the growth in the LIC's export earnings (which measures their ability to service U.S. dollar-denominated debts). Yet the LIC's were able to reduce their debt-export ratios from 158 percent in 1983 to 151 percent in 1984 due to their reduced net borrowing and strong increase in export earnings.

Both official and market borrowers experienced an increased debt-export ratio during 1980-83. But unlike the market borrowers, the ratio was expected to increase for official borrowers until 1986. Debt-export ratios of official borrowers in Sub-Saharan Africa amount to more than 300 percent. Despite the concessional terms associated with much of this debt, the size of the debt in relation to exports will generate strong debt service pressure, as expressed in interest payment ratio. While Asia and Europe maintained stable and relatively low interest payments ratios during 1981-84, the ratio is rising in Sub-Saharan Africa, indicating that the growth in much of the region's debt service liabilities continues to outpace the improvement in debt service capacity. However, the market borrowers in the Western Hemisphere have the highest interest payments ratios of all regions.

### Output Growth

Increased economic growth accompanied the improved external debt situation of LIC's in 1984. Among the non-oil exporting developing countries, the increase in output increased to 4.5 percent from only 2.5 percent per year in 1982-83. Output growth also improved for oil-exporting countries, but only at 2 percent because of the continued low world demand for oil and the associated weakness of the non-oil sector of some countries. Growth for all developing countries increased from 1.5 percent in 1982-83 to 3.5 percent in 1984.



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A marked shift from recession to recovery in the industrialized world partly caused this output growth. Recovery in the industrialized countries was essential for the growth in LIC's. Three factors of global economic environment are especially important to LIC's macroeconomy: the rate of growth of world trade, changes in commodity prices, and the level of interest rates. Because of stagnant output in the industrialized countries, non-oil exports of developing countries declined markedly in 1980-81 and were negative (less than imports) in 1982. With the onset of recovery, exports of LIC's (except those of oil exporters) responded strongly, rising by 6 percent in volume in 1983 and by 12 percent in 1984.

The increase in LIC real GDP is mainly due to the strong recovery in non-oil exports. A first measure of the exports' contribution to the growth of GDP among the LIC's is their real foreign balances' contribution to the growth of GDP in these countries. In 1984, their foreign balance (including balance of payments and capital flows) improved by 1.5 percentage points, or one-third of the growth of GDP, after having contributed to 1 percentage point in 1983.

However, effects of growing and recovering exports go beyond the movements in the real foreign balance. Growth rates in aggregate trade flows influence the rate of growth of both domestic output and domestic demand (which do not include exports). Domestic demand growth in these countries accelerated from 0.75 percent in 1982, to 1.75 percent in 1983, and to 3 percent in 1984 (*6*).

The shift from recession to recovery also affected prices of primary commodities other than oil. The terms of trade for exporters of non-oil primary commodities improved primarily from resumed growth in the demand for raw materials among the industrialized countries. A marked increase in demand for imports by the industrialized countries in 1983 spurred increases in the LIC's export volume.

The adjustment efforts of the LIC's also contributed to this improved growth in output; they responded promptly to the growing demand arising from recovery in the industrialized countries, thus increasing their exports. According to an IMF report, the measures involved varied too greatly in both content and timing to be meaningfully captured in group averages. Nevertheless, the LIC's improved export performance in 1983 and 1984, which contributed to the acceleration of their economic growth, indirectly measured the impact of adjustment.

Exports in LIC's kept pace with the growth of their export markets during 1977-82 (except in 1981, when early adjustment in some Asian countries caused increases in their exports). But this constant share of markets changed to a share gain in 1983 and 1984 as export growth significantly outpaced market growth. In 1983, the exports of non-oil exporters increased by 6 percent, while the export market increased by 4 percent. In 1984 again, the market for exports increased by 10 percent, while exports increased by 12 percent (this improvement is reflected in the share of non-oil LIC's imports to industrialized countries, which increased from 16.5 percent in 1982 to 18 percent in 1984). The market share indicator reflects the desirability of domestic adjustment in increases in output as well as the advantages of outward-oriented trade policies (*1*).

However, the significant improvement in the macroeconomies of LIC's should be qualified in two important respects. First, the improvement is unevenly distributed and second, the growth achieved in 1984, although better than that in 1982-83, remains very low.

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Reference has already been made to the weaker performance of the oil-exporting countries. This distinction between oil and non-oil exporting countries' economic performance can be highlighted as a distinction between the exporters of predominantly primary products and the exporters of manufactured products. Despite the global recession, growth among exporters of manufactured products averaged 5.75 percent annually during 1980-84, whereas primary product exports grew only 1 percent.[7] But these two groups of countries are linked differently to the world economy. The global recession seriously affected the primary commodity export market, and growth in the primary product exporting group turned negative in 1983. When export receipts strengthened in 1984, growth in the primary product exporting group increased to 3 percent.

These differences naturally carry over to geographical areas. Asia (which includes many exporters of manufactured products) recorded an average growth rate of 6.5 percent in 1984, continuing the relatively strong performance in a region largely unaffected by the difficulties faced in other regions. Sub-Saharan Africa, with a less favorable export structure, shortcomings in policies, and a prolonged drought, had a GDP increase of only 1.5 percent. The average growth rate in this region during the past 8 years averaged only 2 percent, much less than the population growth rate.

Output increases in the Western Hemisphere since 1981 were also well below average, although the 2.5-percent growth rate achieved in 1984 improved from the 3-percent decline in output in 1983.

Financial constraints also brought geographical disparities in output growth. Growth rates of market borrowers were lower than those of the official borrowers each year during 1981-83: the average growth rate was only 0.5 percent per year for market borrowers and was 2.5 percent for official borrowers. In 1984, both groups recorded a growth rate of 3 percent.

Despite an improved rate of growth in output in 1984 over 1983, it is still very low. The weighted-average growth rate for the LIC's during 1976-79 was 5.5 percent per year, compared with only 3.75 percent in 1984. Further, the LIC's living standard had been under downward pressure during 1980-83. A significant part of their output growth during these years (average of 2 percent annually, well below their population growth rate) had to compensate for losses in terms of trade in order to improve their current account situation and also to finance higher debt service charges. Hence, available real resources for domestic consumption and investment must have been significantly lower per capita during this period.

Apart from the improved export efforts, the impact of IMF adjustment on their economic performance is not clear. Nor is there any way to determine whether the 34 countries with IMF programs in 1985 have performed better or worse than those without an IMF program. Nonetheless, the IMF lent about $27 billion from mid-1972 to 1986 to some 70 member countries that experienced balance of payments problems. Much of these loans were to support adjustment programs, which encouraged other creditors, especially commercial banks, to rollover maturing loans and to provide new money when necessary. The potential crisis in international trade and development to which the IMF responded was thus avoided.

[7] This group includes India and China, the two most populous countries.



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## IMF'S DIRECTION IN 1986-90

The policy issues confronting the LIC's revolve around ways to accelerate growth and maintain a sustainable external position. The world economic conditions as well as commercial and official lending levels will be the critical determining factor. Appropriate macroeconomic policies in the industrialized countries, particularly in the United States, are a basic precondition for balance of payments viability in LIC's. Equally important is the industrialized countries' willingness to provide LIC's liberalized access to their markets.

However, there is a basic question concerning IMF stabilization policies for the remainder of the decade. The fact that external deficits in LIC's have now been reduced to a sustainable level may prompt questions about the appropriateness of demand management as a future instrument. More emphasis should be placed on relaxing supply constraints and allowing a faster rate of domestic demand growth to ease pressures on living standards.

Despite the remarkable improvement in the LIC's balance of payments situation and despite the obvious recognized external causes of their balance of payments fluctuations, existing IMF policies will be maintained, and even strengthened where possible. The role of demand management is re-emphasized, and the roles of the economy-wide prices are stressed in the context of resource allocation and increased domestic savings and investment.

The IMF believes that while there is some scope for easing the demand-management stand, it would be a mistake to try to relax its fiscal and monetary policies (*6*). Prematurely abandoning the fiscal and monetary policies might lead to a setback of the needed structural adjustments just begun in LIC's. The resources used to improve the current account position of LIC's came more from reduced investment than from cuts in domestic savings--as a share of GDP, the overall savings in LIC's remained unchanged during 1981-84, but the share of output spent on investment decreased from 26 percent of GDP in 1981 to 23 percent in 1984. A major effort should be directed toward increasing the investment ratio in LIC's, and to ensure that this increased investment comes primarily from increased domestic savings. Fiscal, monetary, and exchange rate policies should be used to enhance domestic savings and investment in the short and medium terms. Further reduction of the budget deficit from the 4.5 percent of GDP in 1984 should be achieved, which will decrease the rate of monetary and credit expansion, and control inflationary pressure in LIC's. The IMF assumes that better price stability, coupled with realistic interest rates, would increase savings by diverting resources from unproductive hoarding.

The IMF also emphasizes the role of realistic exchange rates in domestic and external adjustment, particularly in medium-term structural adjustment, which is tied to the development strategy to be pursued in LIC's. The IMF presumes that an outward-looking strategy of economic development exploits the dynamics of world markets, promotes the exchange of technology, attracts foreign resources, and encourages the emergence of a set of relative prices that promotes efficient resource allocation. The IMF also recognizes that against these advantages, greater involvement in world markets involves greater vulnerability to developments originating in these markets, such as fluctuations in export demand, increases in interest costs, adverse terms of trade shifts, and protectionist measures. An important issue facing national authorities in developing countries is the extent to which this vulnerability to outside disturbances offsets the potential advantages of outward-looking policies (*6*).

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The outward-looking strategy currently advocated by the IMF differs from the conventional export-oriented strategy in that the outward-looking strategy encourages certain types of import-substitution production. The outward-looking strategy includes ". . . factor-prices that are permitted to reflect relative scarcities; goods prices that respond to relative prices in world markets; and an emphasis on encouraging those types of output that enjoy at least a reasonable degree of comparative advantage" (*6*). The IMF argues that demand-management policies can steer an economy in an outward-looking direction by restoring financial stability and preventing inflationary dynamics. Realistic (higher) interest and exchange rates, essential for a proper relationship between consumption and savings as well as domestic and foreign goods, must guide the allocation of resources.

Pricing policies, as discussed previously, favor urban consumers at the expense of rural producers. Pricing policies are also regressive from an income-distribution perspective, and discourage agricultural investment, lower national savings, raise urban unemployment, and reduce export supplies.

Exchange rate overvaluation is an adjunct to such pricing policies that discourage export promotion and lead to rationing of imports, shortages, and abuse. Sub-Saharan Africa is a region where the serious backsliding from a recent move toward more realistic exchange rates could occur (*6*).

Other controls and regulations that inhibit new capital formation and reduce the efficiency of existing investment include: restraint on foreign direct investment, foreign exchange surrender requirement, protection from foreign competition, and other restraints on the foreign exchange market. The management and efficiency of the public enterprises is also a concern. Public-sector investment is another important area requiring structural reform (*6*).

## CONCLUSION

Recent events demonstrate the importance of cyclical fluctuations in the industrialized countries to the LIC's balance of payments. The recent developments also show the LIC's flexibilities in adjusting to financial constraints imposed by a crisis of confidence of the commercial lenders. The IMF now emphasizes an outward-looking strategy of development and complete laissez-faire policies in domestic and international economic issues.

### A Time for Re-evaluation

The IMF's policy package goes contrary to the political and economic philosophies adopted at independence by most LIC's. Each country must now re-evaluate the policy alternatives open for achieving and maintaining stability with growth in the medium term. This report has analyzed the probable effects of the instruments of the IMF stabilization program and the complexities involved in determining outcomes of the policies, individually and collectively. There is a lack of general agreement among economists on all those policy issues.

What is mainly at issue over the IMF role is a difference in perspective about the nature of the basic structural problems. Even if one accepts the IMF position that the present demand-management strategy must continue, supply-management policies must also be pursued:



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> For many of these countries the difficulties are not so much debt problems (actually their debt ratios are often lower than those of the Latin American countries) but developmental problems. In such countries, where the resource base is very weak, adjustment measure[s] rarely lead to a quick rebound in their external payments positions. In those cases it is absolutely clear that the name of the game is structural adjustment aimed at strengthening supply conditions; this process needs the support of stable domestic conditions and longterm foreign assistance. . . the role of the World Bank in catalyzing external assistance and in providing support for these structural programs is very important. The role of the Fund in appraising macroeconomic policies and providing, in some cases, catalytic financing will also be helpful (*5*, June 24, 1985).

The central issue now is to identify the structural impediments that must be removed or improved upon for LIC's to achieve a high rate of output growth and financial stability in the medium term, say by 1990 (especially for Sub-Saharan Africa, as evident from their recent economic performance in the face of global recovery). The demand-management approach, together with the outward-looking strategy of supply management advocated by the IMF, may not help Sub-Saharan Africa resolve its longer term problems. The World Bank, on the other hand, focuses on project implementation rather than on economic growth. Thus, African countries, especially Sub-Saharan Africa, face a policy vacuum when it comes to external assistance and economic growth, as the many offerings do not necessarily address all the problems.

The IMF and World Bank can help promote world economic stability by designing a new plan to correct those structural and financial problems discussed above, a plan that emphasizies the new economic realities. Collaboration between the IMF, World Bank, and AID (Agency for International Development) would better mesh the shortrun macroeconomic policies of the IMF and the longrun perspective of the development agencies.

In March 1986, the IMF's Executive Board approved a structural adjustment facility designed to assist low-income member countries facing protracted balance of payments problems. This facility is to help LIC's adopt medium-term macroeconomic and structural adjustment programs to correct distortions in their economies, restore viable payments positions, and promote faster economic growth. The World Bank's Executive Board agreed to the broad outlines of the facility's most innovative feature: closer World Bank-IMF collaboration in assisting member countries design these programs.

### A View Toward Sub-Saharan Africa

The agricultural sector in Sub-Saharan Africa is the most important for economic recovery, stabilization, and development. Structures of agricultural production can have important ramifications for agricultural output, output-mix, consumption, employment, income, industrialization, outmigration, exports, and imports. Yet, an appropriate structure of agriculture, by modifying the existing adverse structural features, has not been fully developed in Africa, and may not be developed because of the previously mentioned lack of a needed policy package.

African countries need to provide food of acceptable quality to their people. The responsibility for this lies with the many small farmers who cultivate and produce most crops and livestock. A development with stabilization strategy in Sub-Saharan Africa during the eighties must emphasize developing the small-scale peasant sector and the role of the small producers in planning and decisionmaking (*14*).

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The most important structural feature in Sub-Saharan Africa that constrains agricultural supply is the absence of a green revolution, which has been confined mainly to areas with controlled irrigation in Asia and Latin America. The scope for expanding irrigated agriculture in Africa is limited because of technical and economic constraints. Only recently has there been a real recognition of the special problems of increasing productivity and output among small farmers in rainfed regions. (There have been some notable successes such as the spread of hybrid maize in certain farming areas in Kenya.) The level of rainfall, its yearly variability, and its seasonal distribution limit significantly the increases that can be obtained simply by introducing improved seed-fertilizer combinations, especially in the semi-arid tropical regions (*13*).

Many irrigation projects in Sub-Saharan Africa were not cost-effective because few farmers benefited from the investment. The physical environment, another structural feature, offers relatively few low-cost sites for irrigation projects. (There are a few examples of successful irrigation projects, most notably the Gezira Project in the Sudan. That scheme owes its success, however, to soil and other conditions suitable to producing long-staple cotton, a high-value crop. The same is true for the Mwea irrigation project in Kenya.) The opportunity cost of ill-advised irrigation projects is generally very high. Irrigated agriculture is expensive and too technically demanding in Sub-Saharan Africa. Resources should be redirected, in the short and medium term to remove this structural bottleneck, by focusing on developing drought-resistant crops and by providing inputs to increase small-farm output in rainfed areas.

Policies toward taxing agricultural export earnings to collect foreign exchange and pay for economic development in many African nations may have retarded the development of their agricultural sectors and limited increases in their food supply. Moreover, money allocated for agricultural development has been less than adequate, despite the many "feed the nation" projects.

An appropriate price policy as a producer incentive is important. However, others argue that food prices in many African countries are now market-determined. Parallel markets operate, and prices for many products reflect official prices. Low world market prices constrain production for export; the scope for raising output through increased producer prices is therefore limited. The exchange rate policy in many cases also is of less economic significance because of the substantial border trade which takes place at market-determined rates (*2*).

Other fundamental structural and institutional features of the African countries are their recent concept of nationhood, limited entrepreneurial heritage, and active government roles in the economy. Rising nationalism places ever-expanding demands on governments for better education and health, more jobs, more food, and other demands which often surpass the productive capacity of the economy (*9*). While the political feasibility of the current IMF supply-oriented programs (exchange rate and other price reforms) has been questioned, the type of output-increasing strategy suggested in this report is likely to be welcomed by most African nations because these policies conform to their perception of the expected roles governments should play.

These and other structural barriers to supply should be the focus of attention during the remainder of the eighties, to stabilize and develop Sub-Saharan Africa by 1990.



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**The United States has a vital stake in the economic adjustment of LIC's, especially those in Sub-Saharan Africa. A healthy growth of LIC's is essential for safeguarding the economic, financial, and commercial, as well as the strategic, interests of the United States.**

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Appendix table 1--Current account financing in indebted developing countries, by class of creditor, 1977-86

| Item | Accounts in: | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
| | Billion dollars | | | | | | | | | |
| Indebted LIC's: | | | | | | | | | | |
| Current account deficit[1] | 36.9 | 56.8 | 61.7 | 77.0 | 112.6 | 102.9 | 59.4 | 37.9 | 38.2 | 36.7 |
| Nondebt-creating flows | 14.9 | 17.6 | 24.7 | 24.4 | 28.0 | 28.6 | 22.9 | 22.7 | 25.1 | 26.9 |
| Official transfers | 8.3 | 8.3 | 11.7 | 12.5 | 13.5 | 13.0 | 12.9 | 13.1 | 14.8 | 15.4 |
| Direct investment flows, net | 6.0 | 7.9 | 10.1 | 9.4 | 14.0 | 12.8 | 9.9 | 9.1 | 9.9 | 11.0 |
| SDR allocations, valuation adjustments, and gold monetization[2] | .6 | 1.4 | 2.9 | 2.5 | .5 | 2.9 | .1 | .5 | .5 | .5 |
| Use of reserves | -10.7 | -13.5 | -21.5 | -18.4 | 1.6 | 14.4 | -9.5 | -22.3 | -11.2 | -11.0 |
| Asset transactions, net[3] | -6.2 | -4.9 | -7.8 | -7.8 | -17.4 | -12.9 | -8.2 | -5.8 | -9.1 | -11.2 |
| Recorded errors and omissions[4] | -6.5 | -4.9 | -3.4 | -19.1 | -19.7 | -24.9 | -11.4 | -3.6 | -- | -- |
| Net external borrowing | 45.5 | 62.5 | 69.7 | 97.9 | 120.1 | 97.7 | 65.7 | 46.9 | 33.3 | 32.0 |
| Reserve-related liabilities | 3.4 | 1.5 | -.8 | 4.2 | 8.9 | 19.2 | 17.3 | 3.7 | -5.0 | -2.6 |
| Liabilities constituting foreign authorities reserves[5] | 2.0 | 1.4 | -1.3 | 1.9 | 0.9 | 1.1 | -1.3 | -.2 | .9 | 2.1 |
| Use of Fund credit[6] | -.2 | -.4 | .2 | 1.5 | 6.0 | 7.0 | 11.0 | 5.3 | 1.8 | -5.4 |
| Arrears | 1.6 | .5 | .4 | .8 | 2.0 | 11.1 | 7.5 | -1.3 | -7.7 | .8 |
| Long-term borrowing from official creditors, net[7] | 13.8 | 16.2 | 18.1 | 24.1 | 27.1 | 30.4 | 29.3 | 29.5 | 28.5 | 24.4 |
| Other net external borrowing[8] | 28.2 | 44.8 | 52.4 | 69.7 | 84.1 | 48.1 | 19.1 | 13.6 | 9.8 | 10.2 |
| Long term | 13.5 | 34.9 | 42.8 | 39.3 | 60.9 | 34.7 | 36.4 | 24.5 | 31.3 | 8.1 |
| From banks[9] | 8.1 | 27.7 | 29.7 | 23.9 | 32.8 | 21.4 | 38.0 | 23.0 | 31.3 | 8.0 |
| Other | 5.4 | 7.3 | 13.1 | 15.4 | 28.2 | 13.2 | -1.5 | 1.5 | -- | .1 |
| Short term | 14.7 | 9.8 | 9.6 | 30.4 | 23.1 | 13.4 | -17.3 | -10.9 | -21.4 | 2.1 |
| Indebted LIC's that are market borrowers: | | | | | | | | | | |
| Current account deficit[1] | 19.5 | 32.8 | 30.3 | 35.6 | 72.2 | 73.6 | 29.8 | 8.4 | 8.6 | 5.8 |
| Nondebt-creating flows, net | 5.8 | 8.7 | 11.1 | 10.1 | 13.1 | 15.5 | 9.8 | 9.5 | 10.2 | 11.2 |
| Official transfers | .8 | 1.0 | 1.2 | 1.3 | 1.8 | 1.9 | 2.2 | 2.2 | 2.3 | 2.4 |
| Direct investment flows, net | 4.5 | 6.4 | 7.8 | 7.6 | 11.1 | 10.5 | 7.5 | 6.8 | 7.5 | 8.3 |
| SDR allocations, valuation adjustments, and gold monetization[2] | .6 | 1.4 | 2.2 | 1.2 | .2 | 3.0 | -- | .4 | .4 | .5 |
| Use of reserves | -6.0 | -10.5 | -18.2 | -17.3 | 2.4 | 22.3 | -4.6 | -18.8 | -9.3 | -9.4 |
| Asset transactions, net[3] | -3.8 | -2.9 | -4.1 | -4.7 | -14.1 | -9.9 | -4.1 | -3.9 | -7.1 | -8.9 |
| Recorded errors and omissions[4] | -4.6 | -4.3 | -3.5 | -19.7 | -20.5 | -24.2 | -10.5 | -2.8 | -- | -- |
| Net external borrowing | 28.1 | 41.8 | 45.0 | 67.1 | 91.3 | 70.0 | 39.3 | 24.3 | 14.8 | 12.9 |
| Reserve-related liabilities | .5 | -.9 | -1.9 | .8 | 2.4 | 13.8 | 14.8 | 2.3 | -5.2 | -2.1 |
| Liabilities constituting foreign authorities reserves[5] | .6 | -- | -1.5 | .2 | .5 | 1.6 | -1.1 | -.2 | -.1 | -.1 |
| Use of Fund credit[6] | -.1 | -.9 | -.4 | .6 | 1.8 | 3.0 | 7.3 | 4.3 | 3.1 | -2.4 |
| Arrears | -- | -- | -- | -- | -- | 9.2 | 8.6 | -1.7 | -8.1 | .3 |
| Long-term borrowing from official creditors, net[7] | 5.5 | 6.5 | 5.3 | 6.9 | 8.4 | 11.7 | 15.5 | 11.5 | 14.0 | 10.1 |
| Other net external borrowing[8] | 22.1 | 36.2 | 41.5 | 59.5 | 80.6 | 44.5 | 9.0 | 10.5 | 6.0 | 5.0 |
| Long term | 10.6 | 29.9 | 32.5 | 31.7 | 57.8 | 31.8 | 27.0 | 24.0 | 29.7 | 4.6 |
| From banks[9] | 6.3 | 23.2 | 20.9 | 18.9 | 31.0 | 19.8 | 30.1 | 23.2 | 31.7 | 5.2 |
| Other | 4.2 | 6.7 | 11.5 | 12.8 | 26.8 | 12.0 | -3.1 | .8 | -2.0 | -.6 |
| Short term | 11.6 | 6.3 | 9.1 | 27.8 | 22.8 | 12.7 | -18.0 | -13.5 | -23.7 | .4 |

See footnotes at end of table.

Continued--

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Appendix table 1--Current account financing in indebted developing countries, by class of creditor, 1977-86--Continued

| Item | Accounts in: | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
| | Billion dollars | | | | | | | | | |
| Indebted LIC's that are official borrowers: | | | | | | | | | | |
| Current account deficit[1] | 8.4 | 11.5 | 12.9 | 16.9 | 19.3 | 18.0 | 15.4 | 16.8 | 17.2 | 17.0 |
| Nondebt-creating flows | 4.9 | 4.6 | 7.2 | 8.0 | 8.5 | 7.8 | 7.1 | 7.0 | 7.1 | 7.2 |
| Official transfers | 4.2 | 3.9 | 6.3 | 7.1 | 7.4 | 7.2 | 6.5 | 6.4 | 6.6 | 6.6 |
| Direct investment flows, net | .7 | .7 | .7 | .5 | 1.0 | .7 | .5 | .5 | .5 | .6 |
| SDR allocations, valuation adjustments, and gold monetization[2] | -- | -- | .2 | .4 | .1 | -- | -- | .1 | -- | -- |
| Use of reserves | -1.9 | -.6 | -.9 | -.5 | .3 | .8 | -.9 | 1.5 | 1.4 | 1.3 |
| Asset transactions, net[3] | -.4 | -.2 | -.7 | -.9 | -.6 | -.5 | -.5 | -.5 | -.4 | -.4 |
| Recorded errors and omission[4] | -- | .9 | -- | -.3 | .3 | -1.1 | -.6 | -- | -- | -- |
| Net external borrowing | 5.8 | 6.8 | 7.4 | 10.7 | 10.8 | 10.9 | 10.3 | 8.9 | 9.0 | 9.0 |
| Reserve-related liabilities | .3 | .8 | .3 | 2.2 | 2.8 | 3.5 | 1.8 | .8 | .1 | -.7 |
| Liabilities constituting foreign authorities reserves[5] | .1 | .3 | -- | 1.5 | .6 | .3 | -.1 | .1 | -- | .2 |
| Use of Fund credit[6] | -- | .2 | .5 | .2 | 1.8 | 1.3 | 1.6 | .4 | -.4 | -1.3 |
| Arrears | .1 | .2 | -.2 | .5 | .5 | 1.9 | .3 | .3 | .4 | .4 |
| Long-term borrowing from official creditors, net[7] | 3.1 | 4.2 | 6.5 | 8.4 | 9.2 | 9.2 | 7.7 | 9.0 | 7.1 | 9.5 |
| Other net external borrowing[8] | 2.4 | 1.9 | .6 | .1 | -1.2 | -1.8 | .8 | -.9 | 1.8 | .2 |
| Long term | 1.5 | 1.5 | .1 | -- | -.8 | -.9 | 1.1 | -.3 | .9 | .1 |
| Short term | .9 | .3 | .4 | .1 | -.4 | -.9 | -.3 | -.6 | .9 | .1 |

Note: Except where otherwise footnoted, estimates shown here are based on national balance of payments statistics, which are not always easily reconcilable with yearly changes in either debtor- or creditor-reported debt statistics, mainly because the balance of payments statistics include valuation adjustments as well as changes in liabilities.

-- = Less than +/- 0.1.

[1]Net total balances on goods, services, and private transfers, as defined in the Fund's Balance of Payments Statistics.

[2]SDR = Special Drawing Rights.

[3]Pertains primarily to export credit.

[4]Positioned here on the presumption that estimates reflect primarily unrecorded capital outflows.

[5]Comprises short-term borrowing by monetary authorities from other monetary authorities.

[6]Projected use of Fund credit does not take into account prospective programs.

[7]Estimates of net disbursements by official creditors (other than monetary institutions).

[8]Residually calculated. Except for minor discrepancies in coverage, amounts shown reflect almost exclusively net external borrowing from private creditors.

[9]Refers only to long-term lending by banks guaranteed by government of debtor country. Bank lending also accounts for large fractions of unguaranteed long-term flows (included in "other" long-term flows) and short-term flows.

Source: International Monetary Fund, World Economic Outlook, April 1985, pp. 250-51.



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Appendix table 2--Current account financing in indebted developing countries, by region, 1977-86

| Region and financing | Accounts in: | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
| | Billion dollars | | | | | | | | | |
| **Africa:** | | | | | | | | | | |
| Current account deficit | 10.4 | 15.4 | 6.6 | 5.3 | 25.2 | 24.4 | 15.5 | 10.9 | 9.8 | 8.8 |
| Use of reserves | .6 | 1.9 | -4.5 | -6.3 | 7.2 | 4.4 | -.4 | .2 | .4 | .9 |
| Asset transactions, net | -1.2 | -1.0 | -1.7 | -1.2 | -1.8 | -.6 | -.9 | -.3 | -.1 | -.2 |
| Errors and omissions | -1.0 | .2 | -1.3 | -.7 | .7 | -1.7 | -2.0 | -.3 | -- | -- |
| Non-debt-creating flows, net | 3.7 | 3.6 | 4.9 | 4.4 | 3.7 | 5.1 | 5.0 | 4.4 | 4.7 | 5.0 |
| Net external borrowing | 8.3 | 10.7 | 9.2 | 9.2 | 15.4 | 17.2 | 13.9 | 6.9 | 4.8 | 3.2 |
| Long-term borrowing from official creditors | 3.7 | 3.3 | 6.0 | 6.5 | 7.1 | 9.6 | 6.1 | 6.3 | 4.1 | 3.7 |
| Reserve-related liabilities | .3 | .6 | -- | 1.6 | 2.6 | 7.5 | 5.6 | -1.9 | .9 | .5 |
| Other borrowing | 4.3 | 6.8 | 3.3 | 1.0 | 5.7 | .1 | 2.2 | 2.4 | -.2 | -1.1 |
| **Asia:** | | | | | | | | | | |
| Current account deficit | .9 | 8.9 | 15.2 | 21.8 | 23.4 | 19.8 | 16.3 | 7.9 | 8.2 | 8.7 |
| Use of reserves | -6.0 | -4.8 | -6.0 | -6.8 | -6.9 | -6.0 | -8.2 | -10.8 | -8.6 | -9.6 |
| Asset transactions, net | -2.0 | -- | -2.2 | -.6 | -3.0 | -1.8 | -2.1 | -5.3 | -6.3 | -7.7 |
| Errors and omissions | -.8 | -1.1 | .1 | -2.0 | -3.1 | -4.8 | -2.5 | -.3 | -- | -- |
| Non-debt-creating flows, net | 3.5 | 4.7 | 5.4 | 6.8 | 8.7 | 6.5 | 6.8 | 6.7 | 6.7 | 7.2 |
| Net external borrowing | 6.2 | 10.0 | 18.0 | 24.4 | 27.7 | 25.9 | 22.4 | 17.6 | 16.3 | 18.8 |
| Long-term borrowing from official creditors | 2.9 | 4.4 | 4.4 | 6.8 | 10.4 | 9.7 | 8.9 | 10.6 | 11.4 | 11.5 |
| Reserve-related liabilities | -.3 | -.2 | -.1 | 1.3 | 3.2 | 2.6 | 4.2 | .9 | -3.4 | -1.4 |
| Other borrowing | 3.6 | 5.8 | 13.6 | 16.3 | 14.1 | 13.6 | 9.2 | 6.1 | 8.3 | 8.7 |
| **Europe:** | | | | | | | | | | |
| Current account deficit | 9.0 | 7.1 | 9.9 | 12.5 | 10.5 | 6.7 | 5.3 | 3.3 | 2.7 | 1.8 |
| Use of reserves | 1.1 | -.9 | 1.1 | -.5 | .1 | 1.4 | -.1 | -2.7 | -.3 | -.1 |
| Asset transactions, net | .7 | -- | .5 | .3 | -.8 | -1.5 | .4 | .1 | -- | -.2 |
| Errors and omissions | -1.0 | -1.1 | .5 | -1.1 | 1.0 | .7 | -1.9 | -.1 | -- | -- |
| Non-debt-creating flows, net | .7 | .7 | 1.1 | 1.1 | 1.2 | 1.3 | 1.6 | 1.7 | 1.7 | 1.8 |
| Net external borrowing | 7.5 | 8.3 | 6.8 | 12.8 | 9.1 | 4.9 | 6.0 | 4.4 | 1.3 | .2 |
| Long-term borrowing from official creditors | 1.2 | 2.7 | 1.1 | 3.7 | 2.7 | 2.5 | 1.0 | 2.3 | .2 | -.3 |
| Reserve-related liabilities | 2.4 | .4 | -.5 | -.3 | 2.2 | .4 | .5 | .5 | -.8 | -1.0 |
| Other borrowing | 3.9 | 5.2 | 6.2 | 9.4 | 4.2 | 2.0 | 4.5 | 1.6 | 1.9 | 1.6 |
| **Non-oil Middle East:** | | | | | | | | | | |
| Current account deficit | 5.0 | 6.0 | 8.2 | 8.1 | 10.5 | 9.8 | 10.6 | 10.3 | 10.1 | 10.5 |
| Use of reserves | -1.7 | -1.7 | -.9 | -1.3 | -.1 | -1.7 | 1.4 | 1.5 | .3 | .2 |
| Asset transactions, net | -1.2 | -1.3 | -2.0 | -3.1 | -1.8 | -1.1 | -1.5 | -.5 | -.7 | .9 |
| Errors and omissions | -.3 | .1 | .7 | .5 | .4 | 1.3 | 1.0 | -- | -- | ... |
| Non-debt-creating flows, net | 4.1 | 3.5 | 6.2 | 5.4 | 6.2 | 5.5 | 4.9 | 5.0 | 6.5 | 7.1 |
| Net external borrowing | 4.0 | 5.5 | 5.6 | 6.7 | 5.7 | 5.8 | 4.8 | 4.4 | 4.0 | 4.2 |
| Long-term borrowing from official: creditors | 3.3 | 3.3 | 3.8 | 2.9 | 2.6 | 3.5 | 2.1 | 3.2 | 4.4 | 2.2 |
| Reserve-related liabilities | 1.4 | 1.0 | -- | -.2 | -.5 | -.4 | -.2 | -- | -- | -.1 |
| Other borrowing | -.7 | 1.2 | 1.8 | 4.0 | 3.6 | 2.7 | 2.8 | 1.2 | -.4 | 2.0 |

See footnotes at end of table.

Continued--



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Appendix table 2--Current account financing in indebted developing countries, by region, 1977-86--Continued

| Region and financing | Accounts in: | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
| | Billion dollars | | | | | | | | | |
| Western Hemisphere: | | | | | | | | | | |
| Current account deficit | 11.6 | 19.4 | 21.7 | 29.3 | 43.1 | 42.1 | 11.7 | 5.5 | 7.5 | 6.8 |
| Use of reserves | -4.8 | -8.0 | -11.2 | -3.5 | 1.3 | 16.2 | -2.3 | -10.5 | -2.9 | -2.4 |
| Asset transactions, net | -2.5 | -2.5 | -2.4 | -3.2 | -10.0 | -7.8 | -3.3 | .2 | -1.9 | -2.3 |
| Errors and omissions | -3.4 | -3.1 | -2.1 | -15.7 | -18.6 | -20.4 | -6.0 | -2.8 | -- | -- |
| Non-debt-creating flows, net | 2.8 | 4.9 | 7.2 | 6.8 | 8.3 | 10.2 | 4.6 | 5.0 | 5.4 | 5.9 |
| Net external borrowing | 19.4 | 28.0 | 30.2 | 45.0 | 62.2 | 43.9 | 18.6 | 13.6 | 6.8 | 5.6 |
| Long-term borrowing from official creditors | 2.7 | 2.5 | 2.8 | 4.2 | 4.3 | 5.1 | 11.1 | 7.1 | 8.4 | 7.3 |
| Reserve-related liabilities | -.4 | -.2 | -.1 | 1.8 | 1.4 | 9.1 | 7.1 | 4.2 | -1.7 | -.6 |
| Other borrowing | 17.1 | 25.8 | 27.6 | 39.0 | 56.5 | 29.7 | .3 | 2.3 | .2 | -1.1 |

-- = Less than +/- 0.1.

Source: International Monetary Fund, World Economic Outlook, April 1985, pp. 252-53.



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Appendix table 3--Summary of current account financing in indebted LIC's, 1977-86

| Analytical subgroups of LIC's | Accounts in: | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
| | Billion dollars | | | | | | | | | |
| Countries with recent debt-servicing problems: | | | | | | | | | | |
| Current account deficit | 27.5 | 37.4 | 39.1 | 47.7 | 66.7 | 61.7 | 25.6 | 14.6 | 15.7 | 13.1 |
| Use of reserves | -2.2 | -6.1 | -11.5 | -7.1 | 7.9 | 19.3 | -4.0 | -12.7 | -3.5 | -2.3 |
| Asset transactions, net | -3.4 | -3.2 | -2.1 | -3.5 | -11.7 | -9.8 | -4.3 | -- | -2.2 | -2.9 |
| Errors and omissions | -4.7 | -3.7 | -3.2 | -16.7 | -18.4 | -21.1 | -6.7 | -1.6 | -- | -- |
| Nondebt-creating flows, net | 5.9 | 7.9 | 11.4 | 9.9 | 11.1 | 13.5 | 7.9 | 7.8 | 9.0 | 9.7 |
| Net external borrowing | 31.8 | 42.4 | 44.5 | 65.1 | 77.8 | 59.8 | 32.7 | 21.2 | 12.5 | 8.5 |
| Long-term borrowing from official creditors | 6.8 | 8.0 | 8.9 | 13.1 | 14.2 | 16.4 | 17.5 | 14.5 | 13.4 | 10.3 |
| Reserve-related liabilities | 1.2 | 1.0 | .9 | 4.7 | 6.7 | 16.3 | 14.7 | 2.8 | -3.6 | -.4 |
| Other borrowing | 23.8 | 33.4 | 34.8 | 47.3 | 56.9 | 27.0 | .4 | 4.0 | 2.6 | -1.4 |
| Countries without debt-servicing problems: | | | | | | | | | | |
| Current account deficit | 9.4 | 19.4 | 22.6 | 29.3 | 45.9 | 41.2 | 33.8 | 23.2 | 22.4 | 23.6 |
| Use of reserves | -8.5 | -7.4 | -10.0 | -11.3 | -6.2 | -5.0 | -5.6 | -9.6 | -7.7 | -8.7 |
| Asset transactions, net | -2.9 | -1.7 | -5.7 | -4.4 | -5.7 | -3.1 | -3.9 | -5.8 | -6.9 | -8.4 |
| Errors and omissions | -1.9 | -1.2 | -.2 | -2.4 | -1.3 | -3.8 | -4.7 | -2.0 | -- | -- |
| Nondebt-creating flows, net | 9.0 | 9.7 | 13.3 | 14.5 | 16.8 | 15.2 | 14.9 | 14.9 | 16.1 | 17.2 |
| Net external borrowing | 13.7 | 20.1 | 25.2 | 32.8 | 42.3 | 38.0 | 33.0 | 25.7 | 20.9 | 23.5 |
| Long-term borrowing from official creditors | 7.1 | 8.3 | 9.2 | 11.0 | 12.9 | 14.0 | 11.7 | 15.1 | 15.1 | 14.1 |
| Reserve-related liabilities | 2.1 | .5 | -1.6 | -.5 | 2.2 | 2.9 | 2.6 | 1.0 | -1.4 | -2.1 |
| Other borrowing | 4.4 | 11.3 | 17.6 | 22.3 | 27.2 | 21.1 | 18.7 | 9.6 | 7.2 | 11.5 |
| Small LIC's: | | | | | | | | | | |
| Current account deficit | 5.7 | 8.7 | 10.2 | 12.5 | 13.0 | 12.7 | 10.0 | 11.5 | 12.1 | 11.8 |
| Use of reserves | -1.0 | .2 | -.3 | -.2 | .3 | .1 | -1.3 | 1.2 | 1.1 | 1.0 |
| Asset transactions, net | -.5 | -.2 | -.3 | -.4 | -.1 | -.2 | -.1 | -- | -- | -- |
| Errors and omissions | .2 | .5 | .1 | .1 | -- | -.1 | -.3 | -.1 | -- | -- |
| Nondebt-creating flows, net | 2.8 | 3.0 | 4.0 | 4.4 | 4.4 | 4.6 | 4.5 | 4.6 | 4.7 | 4.8 |
| Net external borrowing | 4.1 | 5.1 | 6.7 | 8.5 | 8.4 | 8.2 | 7.3 | 5.8 | 6.2 | 6.0 |
| Long-term borrowing from official creditors | 2.5 | 2.9 | 5.0 | 6.5 | 6.7 | 6.7 | 5.3 | 6.4 | 5.7 | 7.2 |
| Reserve-related liabilities | .1 | .3 | .1 | 1.5 | 1.8 | 2.2 | .9 | .3 | -.2 | -.8 |
| Other borrowing | 1.5 | 2.0 | 1.6 | .6 | -.1 | -.7 | 1.2 | -.8 | .8 | -.4 |
| Sub-Saharan Africa:[1] | | | | | | | | | | |
| Current account deficit | 4.2 | 7.7 | 8.1 | 11.2 | 12.2 | 11.2 | 8.9 | 7.9 | 8.3 | 7.8 |
| Use of reserves | -.8 | .1 | -.3 | .2 | .3 | .6 | -.2 | -.1 | .3 | .4 |
| Asset transactions, net | -.7 | -.1 | -.3 | -.7 | -.8 | -.3 | -.3 | -.2 | -.1 | -.1 |
| Errors and omissions | -.2 | .6 | -- | .5 | .6 | -.7 | -.5 | -.3 | -- | -- |
| Nondebt-creating flows, net | 2.3 | 2.8 | 3.6 | 4.5 | 4.2 | 4.0 | 4.1 | 4.0 | 4.3 | 4.3 |
| Net external borrowing | 3.5 | 4.2 | 5.1 | 6.7 | 7.9 | 7.6 | 5.9 | 4.5 | 3.8 | 3.2 |
| Long-term borrowing from official creditors | 2.0 | 2.1 | 4.5 | 4.9 | 4.7 | 5.5 | 3.9 | 4.3 | 3.5 | 4.5 |
| Reserve-related liabilities | .2 | .7 | .3 | 1.6 | 2.3 | 2.2 | 1.5 | .1 | -.2 | -.8 |
| Other borrowing | 1.3 | 1.4 | .3 | .3 | .9 | -.1 | .4 | -.8 | .5 | -.4 |

-- = Less than +/- 0.1.
[1]Excluding Nigeria and South Africa.

Source: International Monetary Fund, World Economic Outlook, April 1985, p. 255.

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